

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 211

[Release No. SAB 103]

Staff Accounting Bulletin No. 103, "Update of Codification of Staff Accounting Bulletins"

AGENCY: Securities and Exchange Commission.

ACTION: Publication of staff accounting bulletin.

SUMMARY: This staff accounting bulletin revises or rescinds portions of the interpretive guidance included in the codification of staff accounting bulletins in order to make this interpretive guidance consistent with current authoritative accounting and auditing guidance and SEC rules and regulations. The principal revisions relate to the rescission of material no longer necessary because of private sector developments in U.S. generally accepted accounting principles, as well as Commission rulemaking.

DATES: Effective May 9, 2003.

FOR FURTHER INFORMATION CONTACT: Paul Munter or Jack Albert, Office of the Chief Accountant (202-942-4400), or Craig Olinger, Division of Corporation Finance (202-942-2960), Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549.

SUPPLEMENTARY INFORMATION:

Background

The last comprehensive review of the staff accounting bulletins was completed by the staff in 1981, which culminated in issuance of Staff Accounting Bulletin No. 40. At that time, the staff completed a comprehensive review of the material included in staff accounting bulletin numbers 1 through 38 to revise and update such materials, and to codify those staff accounting bulletins in order to make the interpretive guidance contained therein more useful to registrants, accountants and others (Staff Accounting Bulletin No. 39 was separately considered by the staff).

Since that time, the staff has issued 62 additional staff accounting bulletins (through number 102) and occasional amendments (e.g., SAB No. 71A), and has, on a sporadic basis, revised or rescinded the guidance in individual staff accounting bulletins based on subsequent Commission rulemaking activities or developments by private sector accounting and auditing standards-setters. However, a comprehensive review of the guidance

contained in the staff accounting bulletin codification has not been undertaken since 1981.

Recent guidance issued by the Financial Accounting Standards Board (FASB), specifically Statements of Financial Accounting Standards (Statements) 141, *Business Combinations*, 142, *Goodwill and Other Intangible Assets*, 143, *Accounting for Asset Retirement Obligations*, 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, 146, *Accounting for Costs Associated with Exit or Disposal Activities*, 147, *Acquisitions of Certain Financial Institutions—an Amendment of FASB Statements No. 72 and 144 and FASB Interpretation No. 9*, and Interpretations 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others—an Interpretation of FASB Statements No. 5, 57, and 107 and Rescission of FASB Interpretation No. 34 and 46*, *Consolidation of Variable Interest Entities*, revise or supersede certain guidance contained in Accounting Principles Board (APB) Opinions 16, *Business Combinations*, 17, *Intangible Assets*, and 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, Statements 5, *Accounting for Contingencies*, and 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, as well as several issues addressed by the FASB's Emerging Issues Task Force (EITF) and other authoritative guidance. Provisions of the accounting standards identified above that have been revised or superseded were the subject of several staff interpretations included in the staff accounting bulletins. Furthermore, certain guidance contained in many of the staff accounting bulletins either is no longer useful or relevant due to the passage of time, or has been made obsolete by subsequent Commission rulemaking activities.

Therefore, the purpose of this staff accounting bulletin is to comprehensively update the existing codification to enhance the integrity and usefulness of this guidance.

The statements in staff accounting bulletins are not rules or interpretations of the Commission, nor are they published as bearing the Commission's official approval. They represent interpretations and practices followed by the Division of Corporation Finance and the Office of the Chief Accountant in administering the disclosure

requirements of the Federal securities laws.

Dated: May 9, 2003.

Margaret H. McFarland,
Deputy Secretary.

PART 211—[AMENDED]

Accordingly, Part 211 of Title 17 of the Code of Federal Regulations is amended by adding Staff Accounting Bulletin No. 103 to the table found in Subpart B.

Staff Accounting Bulletin No. 103

The staff hereby revises the Staff Accounting Bulletin Series as follows:

1. Topic 1: Financial Statements

a. Topic 1.A is modified to delete the reference to previously-deleted Rules 3-07 and 3-08 of Regulation S-X.

b. Topic 1.B.1 is modified to reflect the provisions of FASB Statement 109, *Accounting for Income Taxes*.

c. Topic 1.D.1 is modified to conform such guidance with the revised disclosure requirements for foreign private issuers required under Form 20-F as a result of the Commission's International Disclosure Standards rule (Exchange Act Release No. 34-41936) which became effective September 30, 2000. The modifications primarily relate to changes in the former reference in this guidance to Item 9 (Management's Discussion and Analysis) of Form 20-F to make the reference consistent with the new non-financial disclosure requirements of this Form.

d. Topic 1.E.1 is deleted. A definition of the term "audit (or examination)," which was the subject of this interpretive guidance, is now provided in Rule 1-02 of Regulation S-X, thus making the guidance contained in this staff accounting bulletin unnecessary.

e. Topic 1.F is modified to change the references in this guidance from Form S-14 to Form S-4, since Form S-4 subsequently replaced Form S-14. This topic is also modified to delete question 3 and the related interpretive response. The guidance contained in this interpretive response, related to the appropriate accounting treatment for costs incurred to register securities issued for the formation of one-bank holding companies, has been superseded by American Institute of Certified Public Accountants' (AICPA) Statement of Position (SOP) 98-5, *Reporting on the Costs of Start-Up Activities*.

f. Topic 1.I is modified to update the former reference in this guidance to the American Institute of Certified Public Accountants' February 1986 Notice to Practitioners, *ADC Arrangements*. *ADC*

Arrangements was originally issued as a notice to practitioners, published in the April 1986 issue of *The Journal of Accountancy*. This notice was subsequently reprinted without modification as Exhibit I to the AICPA's Practice Bulletin 1 dated November 1987. Furthermore, question 8 of this topic is deleted because the guidance contained in this question and interpretive response, which related to transition to the guidance in Topic 1.I, is no longer relevant due to the passage of time. Furthermore, the reference in the interpretive response to question 1 to Rule 1-02(v) of Regulation S-X has been changed to Rule 1-02(w) of Regulation S-X, since this Rule was redesignated in Exchange Act Release No. 34-35094.

g. Topic 1.J, the first paragraph of the interpretive response is modified to remove the reference to specific percentages and refer to the significance tests in Rule 3-05.

h. Topic 1.L is deleted since it refers to the bankruptcy of a specific accounting firm (Laventhol & Horwath) which occurred in 1990.

i. Topic 1.M is modified to update references to authoritative literature such as SAS 99, *Consideration of Fraud in a Financial Statement Audit*, which superseded SAS 82, *Consideration of Fraud in a Financial Statement Audit*.

2. Topic 2: Business Combinations—Note: In June 2001, the FASB issued Statement 141, which superseded APB Opinion 16, and Statement 142 which superseded APB Opinion 17. Paragraph 13 of Statement 141 requires all business combinations within the scope of that statement to be accounted for using the purchase method as described in that statement. The provisions of Statement 141 are applicable to all business combinations initiated after June 30, 2001. The pooling-of-interests method of accounting for business combinations, as provided for in APB Opinion 16, is no longer permitted for business combinations initiated after June 30, 2001. Several of the interpretive questions in this topic relate to the conditions that must be met in order for a business combination to be appropriately accounted for under the pooling-of-interests method. Accordingly, these interpretive questions are no longer needed.

a. Topic 2.A.1 is deleted. This topic addresses the impact of cash contingencies on classifying a combination as a pooling-of-interests. Since business combinations cannot be accounted for using the pooling-of-interests method, the guidance is no longer relevant.

b. Topic 2.A.2 is deleted. This topic contained two interpretive questions regarding how the acquiring corporation should be determined in a purchase business combination, following the guidance in APB Opinion 16. These interpretations were premised on the language contained in paragraph 70 of APB Opinion 16, which indicated that “* * * presumptive evidence of the acquiring corporation in combinations effected by an exchange of stock is obtained by identifying the former common stockholder interests of a combining company which either retain or receive the larger portion of the voting rights in the combined corporation. That corporation should be treated as the acquirer unless other evidence clearly indicates that another corporation is the acquirer.” Guidance on identifying the acquiring entity is now provided in paragraphs 15 through 19 of Statement 141. This guidance provides several factors to be considered in determining the acquiring entity, one of which is the relative voting rights in the combined entity after the combination. The presumptive language contained in APB Opinion 16 was not retained in Statement 141. Therefore, the guidance in Topic 2.A.2 is no longer relevant.

c. Topic 2.A.3 is deleted. This topic provided interpretive guidance regarding the application of the purchase method of accounting for business combinations to acquisitions of financial institutions during a period of unusual economic conditions (*i.e.*, a period of abnormally high interest rates). This guidance focused on: (1) Unique considerations in the allocation of purchase price to acquired tangible and intangible assets in financial institution acquisitions (such as the determination of the fair values of assets acquired, and the identification and valuation of identifiable intangible assets), (2) the appropriate measure of the fair value of deposit liabilities assumed in acquisitions of financial institutions, and (3) the appropriate amortization periods and methods for intangible assets acquired and goodwill arising from financial institution acquisitions. Statements 141 and 147 provide new guidance as to the criteria for recognizing an intangible asset apart from goodwill in a purchase business combination. Statement 142 provides new guidance on the initial recognition and measurement of intangible assets, and the determination of the useful lives and amortization methods for intangible assets subject to amortization. Statement 142 also provides new guidance on accounting for goodwill. Consequently,

the guidance contained in this topic is no longer relevant.

d. Topic 2.A.4 is deleted. This topic provided guidance on the determination of the appropriate amortization period for goodwill arising from financial institution acquisitions which occurred after December 23, 1981 at the time an entity participating in such an acquisition became an SEC registrant. Under the provisions of Statement 142, goodwill is not amortized, but instead must be tested for impairment at least annually following the methodology provided in that statement. Therefore, the guidance in this topic is no longer relevant.

e. Topic 2.A.5 is modified to update the former references to APB Opinion 16 contained therein to the relevant portions of Statement 141, and to otherwise make the language in this guidance consistent with the provisions of Statement 141.

f. Topic 2.A.6 is modified to update the former references to APB Opinion 16 contained therein to the relevant portions of Statement 141, and to otherwise make the language in this guidance consistent with the provisions of Statement 141.

g. Topic 2.A.7 is modified to update the former references to APB Opinion 16 contained therein to the relevant portions of Statement 141, and to otherwise make the language in this guidance consistent with the provisions of Statement 141.

h. Topic 2.A.8 is modified to update the former references to APB Opinion 16 contained therein to the relevant portions of Statement 141, and to otherwise make the language in this guidance consistent with the provisions of Statement 141. Furthermore, footnote 2 is deleted, since this footnote provided transition guidance which is no longer necessary due to the passage of time.

i. Topic 2.A.9 is modified to update the former references to APB Opinion 16 contained therein to the relevant portions of Statement 141, and to otherwise make the language in this guidance consistent with the provisions of Statement 141.

j. Topic 2.B is deleted. It addressed the treatment of merger expenses in a pooling-of-interests combination. Since, under Statement 141, all combinations are treated as purchases, this guidance is no longer necessary.

k. Topic 2.C is deleted. It addressed certain pro forma disclosures required for a pooling-of-interests combination. Since, under Statement 141, all combinations are treated as purchases, this guidance is no longer necessary.

l. Topic 2.D is modified to update the former references to APB Opinion 16 contained therein to the relevant portions of Statement 141, and to otherwise make the language in this guidance consistent with the provisions of Statement 141 and to delete portions of the guidance related to pooling-of-interests accounting.

m. Topic 2.E is deleted. The topic addressed the implications of risk sharing provisions on the classification of a combination as a pooling-of-interests. Since, under Statement 141, all combinations are treated as purchases, this guidance is no longer necessary.

n. Topic 2.F is deleted. This topic addressed the implications of treasury stock transactions following the consummation of a business combination on the classification of a combination as a pooling-of-interest. Since, under Statement 141, all combinations are treated as purchases, this guidance is no longer necessary.

3. Topic 3: Senior Securities

a. Topic 3.C is modified to include a reference to EIT Topic D-98 in the interpretive response to Question 1.

4. Topic 4: Equity Accounts

a. Topic 4.B is retitled. It previously referred to Subchapter S Corporations. Such entities are now referred to as S Corporations.

b. Topic 4.E is modified to revise the interpretive response to be consistent with revisions subsequently made in Rule 5-02.30 of Regulation S-X.

5. Topic 5: Miscellaneous Accounting

a. Topics 5.C.1 and 5.C.2 are deleted. These topics provided interpretive guidance related to the current recognition of tax loss carryforwards under APB Opinion 11, *Accounting for Income Taxes*. APB Opinion 11 has since been superseded by Statement 109 and the guidance contained in these topics is no longer relevant.

b. Topic 5.E, question 1 is modified to add an appropriate reference to FASB Interpretation 46.

c. Topic 5.E, question 2 is modified to remove, in the interpretive response, the reference to APB Opinion 30, since the relevant authoritative guidance that this response was referring to (accounting for the disposal of a segment of a business) has been superseded by Statement 144. Additionally, that interpretive response is modified to remove the reference to ASR 95, *Accounting for Real Estate Transactions Where Circumstances Indicate that Profits Were Not Earned at the Time the*

Transactions Were Recorded, which previously was rescinded.

d. Topic 5.F is modified to delete the reference in the interpretive response to Statement 8, *Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements*, which has since been superseded.

e. Topic 5.J, footnote 1 has been modified to reflect the fact that the FASB has not determined when or whether it will address push down accounting. Additionally, the interpretive response to question 3 has been modified to include reference to the guidance provided in Interpretation 45.

f. Topic 5.M is modified in order to conform this guidance with the provisions of Statement 115, *Accounting for Certain Investments in Debt and Equity Securities*, which superseded Statement 12, *Accounting for Certain Marketable Securities*. The guidance contained in question 1 of this interpretation continues to be relevant, because Statement 115, like Statement 12, requires a determination of whether a decline in the fair value of debt or equity securities is other than temporary. References to the applicable authoritative literature in the interpretive response to this question are changed, and the language in the interpretive response to question 1 is modified, to be consistent with the new authoritative guidance. Question 2 and the related interpretive response are deleted since Statement 115, paragraph 16 now provides relevant guidance on determining the amount of the write down when a decline in fair value is judged to be other than temporary.

g. Topics 5.P.1 and 5.P.2 are deleted. These topics provided interpretive guidance related to APB Opinion 30 and EITF Issues 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)*, and 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination*, as they applied to restructuring provisions. Statement 146 establishes standards for accruing liabilities related to exiting activities and requires that the liability be recorded when it has been incurred and that it be recorded at its fair value. Accordingly, the previous guidance provided in these topics is no longer needed.

h. Topic 5.P.3 is modified to delete the language that referred to the requirements of APB Opinion 30 regarding the reporting of discontinued operations, which has since been superseded by Statement 144. Footnote

13 of this guidance also has been modified and renumbered to make reference to Statement 131, *Disclosures about Segments of an Enterprise and Related Information*, which superseded Statement 14, *Financial Reporting for Segments of a Business Enterprise*. The guidance in this footnote continues to be relevant, considering the revisions hereby made, under Statement 131.

i. Topic 5.P.4 is modified to change the reference in former footnote 16 from Statement 38, *Accounting for Preacquisition Contingencies of Purchased Enterprises*, to Statement 141. Statement 141 superseded Statement 38, although the guidance in Statement 38 was carried forward into the new standard without reconsideration. Therefore, the guidance in this footnote remains relevant. Additionally, the topic is modified to reflect the disclosure requirements of Statement 146.

j. Topic 5.R is deleted. With the issuance of Statement 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, and Interpretation 39, *Offsetting of Amounts Related to Certain Contracts*, this guidance is no longer needed.

k. Topic 5.S, question 4 is modified to change the references in the interpretive response from Statement 96, *Accounting for Income Taxes*, to the relevant provisions in Statement 109. Although Statement 109 superseded Statement 96, the guidance in this interpretive response remains relevant, considering the revisions hereby made, because Statement 109 carried forward the same guidance contained in Statement 96 with respect to quasi-reorganizations.

l. Topic 5.T, footnote 2 is modified to remove reference to APB Opinion 16, which was superseded, and Topic 2.B, which is being deleted.

m. Topic 5.U is modified to add new footnotes 4 and 5 to clarify the guidance applicable to gain deferral situations.

n. Topic 5.V is modified to note that the interpretive guidance therein does not apply to sales of the residual equity in an entity holding nonperforming loans to an unrelated party. Instead, the provisions of Statement 140 apply to such transactions. Also, it is modified to add an appropriate reference to FASB Interpretation 46 and to delete the reference to EITF Topic D-14, *Transactions Involving Special-Purpose Entities*. In addition, footnote 5 has been modified to note that EITF Issue 87-17, *Spinoffs or Other Distributions of Loans Receivable to Shareholders*, was subsequently codified as issue 11 of EITF Issue 01-02, *Interpretations of APB Opinion No. 29*.

o. Topic 5.W is modified to incorporate the guidance of SOP 94–6, *Disclosure of Certain Significant Risks and Uncertainties*.

p. Topic 5.X is deleted. This interpretive guidance expressed the staff's views regarding the accounting for income tax benefits of thrift bad-debt losses. This guidance was intended to serve as interim guidance until a new standard on accounting for income taxes was adopted. The FASB subsequently issued Statement 109 which provides guidance on this issue.

q. Topic 5.Y is modified as follows:

i. The *Facts* section, questions 1, 2, and 3 are deleted. The remaining questions are renumbered. This information is no longer needed because the issues are addressed in SOP 96–1, *Environmental Remediation Liabilities*.

ii. Previously-numbered question 4 is modified to replace the reference to EITF Issue No. 93–5, *Accounting For Environmental Liabilities*, with SOP 96–1 (SOP 96–1 carried forward the guidance previously contained in EITF Issue 93–5). In addition, previously-numbered footnote 3, included in the interpretive response to question 4, is modified to provide the relevant language from Concepts Statement 7, *Using Cash Flow Information and Present Value in Accounting Measurements*.

iii. Previously-numbered question 5 is modified to incorporate guidance from and reference to SOP 96–1.

iv. The interpretive response to previously-numbered question 7 is modified to refer registrants to the disclosure requirements of Statement 143 for legal obligations associated with the retirement of tangible long-lived assets within the scope of that statement and to Interpretation 45 for guarantees.

v. Previously-numbered question 8 and the related interpretive response are deleted. This guidance, related to the appropriate accounting for site restoration costs, post-closure and monitoring costs, or other environmental costs incurred at the end of the useful life of an asset, is no longer relevant due to the issuance of Statement 143, which establishes accounting standards for recognition and measurement of liabilities for asset retirement obligations and associated asset retirement costs.

r. Topic 5.Z.1 is deleted. The guidance in this interpretive response provided the staff's views as to whether the criteria under APB Opinion 30 for presentation as discontinued operations had been met under certain facts and circumstances. Statement 144 provides new guidance on reporting discontinued operations that supersedes the portions

of APB Opinion 30 that addressed this issue. Therefore, this interpretive guidance is no longer relevant.

s. Topic 5.Z.2 is deleted. The guidance in these interpretive responses provided the staff's views as to whether the criteria under APB Opinion 30 for presentation as discontinued operations had been met under certain facts and circumstances. Statement 144 provides new guidance on reporting discontinued operations that supersedes the portions of APB Opinion 30 that addressed this issue. Therefore, this interpretive guidance is no longer relevant.

t. Topic 5.Z.3 is deleted. The guidance in these interpretive responses provided the staff's views as to whether the criteria under APB Opinion 30 for presentation as discontinued operations had been met under certain facts and circumstances. Statement 144 provides new guidance on reporting discontinued operations that supersedes the portions of APB Opinion 30 that addressed this issue. Therefore, this interpretive guidance is no longer relevant.

u. Topic 5.Z.4 is modified to be consistent with the guidance of Statement 144, which superseded the previous guidance of APB Opinion 30.

v. Topic 5.Z.5 is modified to reflect the appropriate terminology from Statement 144 (separate component) rather than that previously provided by APB Opinion 30 (segment of a business), to make other changes related to the accounting provisions of Statement 144, and to remind registrants of the disclosure requirements of Interpretation 45.

w. Topic 5.Z.6 is deleted. This topic provided the staff's views as to whether subsidiaries that a company intends to sell, which cannot be reported as discontinued operations under APB Opinion 30, must be consolidated in the company's financial statements. This interpretive question arose as a result of the "temporary control" exception to consolidation in ARB 51, *Consolidated Financial Statements*, as amended by Statement 94, *Consolidation of all Majority-Owned Subsidiaries*. Statement 144 provides guidance which supersedes the guidance in APB Opinion 30 related to the reporting of discontinued operations. Statement 144 also amended ARB 51 to eliminate the exception to consolidation for a subsidiary for which control is likely to be temporary. Therefore, the interpretive guidance in this topic is no longer relevant.

x. Topic 5.Z.7 is modified to change the reference therein from APB Opinion 30 to Statement 144. Furthermore, the interpretive response is also amended to add language clarifying the staff's

interpretation of the term "dissimilar" based on long-standing staff practice.

y. Topic 5.AA is deleted. Statement 140 superseded the previous guidance on extinguishments of debt. Accordingly, the guidance is no longer needed.

z. Topic 5.CC is modified. Topic 5.CC provides interpretive guidance on certain questions related to the recognition and measurement of impairment of the carrying amount of long-lived assets, certain identifiable intangible assets, and goodwill pursuant to the provisions of Statement 121 and APB Opinion 17. A portion of this guidance has since been superseded by Statements 142 and 144 and is now deleted. The remaining relevant guidance is rewritten so that it is consistent with the requirements of Statements 142 and 144.

6. Topic 6: Interpretations of Accounting Series Releases

a. Topic 6.A.1 is deleted. ASR 166, *Disclosure of Unusual Risks and Uncertainties in Financial Reporting*, has been rescinded. Therefore, the guidance contained in this topic is no longer relevant.

b. Topic 6.F.1 is deleted. This interpretation provided interpretive guidance on the requirements of Rule 12–03 of Regulation S–X. The schedule previously required under Rule 12–03 was eliminated by Exchange Act Release No. 34–35094. Therefore, the guidance contained in this topic is no longer necessary.

c. Topic 6.G.1 is modified as follows:

i. The interpretive response to Question 5 is modified to incorporate the terminology used in Statement 144.

ii. Question 7 and the related interpretive response under sub-section a. to this topic are modified to remove the reference to Form 8, which was rescinded by Exchange Act Release No. 34–31905.

iii. Sub-section c. and the related questions and interpretive responses thereunder are deleted. Item 302(a)(5) of Regulation S–K was amended by Exchange Act Release No. 34–42266 which made the requirements of Item 302(a) of Regulation S–K applicable to any registrant, except a foreign private issuer, that has securities registered pursuant to sections 12(b) or 12(g) of the Exchange Act. Therefore, the guidance contained in these questions and interpretive responses, which related to the former requirements of Item 302(a) of Regulation S–K, no longer applies.

d. Topic 6.G.2.a is modified as follows:

i. Question 4 is modified to refer to cash and cash equivalents rather than to

funds. APB Opinion 19, *Reporting Changes in Financial Position*, referred to flow of funds. Statement 95, *Statement of Cash Flows*, superseded APB Opinion 19 and refers to flow of cash and cash equivalents.

ii. Question 5 is deleted. Question 5 refers to an analysis of changes in each element of working capital, which is consistent with a "funds" model. However, with the provisions of Statement 95, which uses "cash and cash equivalents," this guidance is no longer relevant.

e. Topic 6.G.2.b.1 is modified to add a footnote reference to APB Opinion 20, *Accounting Changes*, which requires disclosure of the nature and justification of a change in accounting principle.

f. Topic 6.H is modified as follows:

i. The *Facts* section is modified to delete item (3), since the related supplemental schedule that this item was referring to (Rule 12–10 of Regulation S–X) was eliminated by Exchange Act Release No. 34–35094.

ii. Topic 6.H.1.b is modified to refer to Rule 17a–5 as currently numbered.

iii. Topic 6.H.2.a is modified to remove the reference to ASR 172, *Notice of Rescission of Guidelines Set Forth in Accounting Series Release No. 148 Pertaining to Classification of Short-Term Obligations Expected to be Refinanced*.

iv. Topic 6.H.4.c and the related question and interpretive response thereunder are deleted. The schedule formerly required pursuant to Rule 12–10 of Regulation S–X was eliminated by Exchange Act Release No. 34–35094. Therefore, this guidance, which related to the disclosures previously required under Rule 12–10, is no longer relevant.

g. Topic 6.I.3 is modified to refer to discontinued operations rather than discontinuance or disposals of business segments so that it is consistent with Statement 144.

h. Topic 6.I.7 is modified to refer to Rule 4–08(h) rather than Rule 4–08(g) to reflect current numbering.

i. Topic 6.K.1 is deleted. This topic provided interpretive guidance related to the early adoption of ASR 302, *Separate Financial Statements Required by Regulation S–X*. This guidance is no longer necessary due to the passage of time.

j. Topic 6.4.b is modified to refer to Rule 1–02(w). The rules for determining significant subsidiaries were previously renumbered and moved to subsection (w).

7. Topic 7: Real Estate Companies

a. Topic 7.A is deleted. This topic provided guidance on the presentation of funds data in quarterly reports on

Form 10–Q for real estate companies. This guidance is no longer relevant due to the issuance Statement 95.

b. Topic 7.B is deleted. This topic provided guidance on the appropriate format for the statement of changes in financial position for registrants engaged in retail land development and sale activities. This guidance is no longer relevant due to the issuance of Statement 95.

8. Topic 8: Retail Companies

a. The *Facts* to Topic 8.A are rewritten to make them more generically applicable to retail companies.

9. Topic 9: Finance Companies

a. Topic 9.A is deleted. This topic provided interpretive guidance on the appropriate accounting for nonrefundable "points" charged by finance companies at the time a loan transaction is closed. Related guidance is now provided in Statement 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, making the continued need for the guidance in this topic unnecessary.

10. Topic 10: Utility Companies

a. In the interpretive response to Topic 10.A, reference to Rule 4–08(j) is deleted since that rule no longer exists.

b. Topic 10.B is deleted. This topic provided interpretive guidance on disclosures that should be made concerning the estimated future costs of storing spent nuclear fuel and decommissioning nuclear generating plants. Statement 143 establishes accounting standards for recognition and measurement of a liability for an asset retirement obligation and the associated asset retirement cost, including required disclosures. Therefore, the guidance in this topic is no longer relevant.

c. Topic 10.C is modified to add a footnote reminding registrants to consider the guidance provided in Interpretation 46.

d. In the interpretive response to Topic 10.D, the second, third and fourth sentences of the final paragraph are deleted. These sentences referred to ASR 122, *Coverage of Fixed Charges*, which has been rescinded. Additionally, a footnote is added to remind registrants of the need to consider the guidance provided in Interpretations 45 and 46 and Statement 133, *Accounting for Derivative Instruments and Hedging Activities* and related literature.

e. Topic 10.E, question 2 and related interpretive response dealing with transition to the requirements of

Statement 90, *Regulated Enterprises—Accounting for Abandonments and Disallowances of Plant Costs* is deleted as no longer necessary due to the passage of time.

f. Topic 10.F is modified to incorporate a footnote to the interpretive response to relate the response to the requirements of SOP 96–1.

11. Topic 11: Miscellaneous Disclosure

a. Topic 11.D is deleted. This topic provided interpretive guidance on the offsetting of related assets and liabilities. This guidance is no longer necessary due to the issuance of Interpretation 39.

b. Question 1 of Topic 11.H.2 is deleted with Questions 2 and 3 being renumbered as Questions 1 and 2. Question 1 and the Interpretive Response are no longer needed in light of the provisions of Statements 15 and 114.

c. Topic 11.J is deleted. This topic provided interpretive guidance on reporting information related to financial guarantees. This guidance is no longer necessary due to the issuance of Interpretation 45.

d. Topic 11.K, footnote one is modified to remove reference to activities of the FASB's financial instruments project which subsequently have been completed.

e. Topic 11.N, footnote 2 is modified to remove reference to Statement 72, *Accounting for Certain Acquisitions of Banking or Thrift Institutions (an Amendment of APB Opinion No. 17, an Interpretation of APB Opinions 16 and 17, and an Amendment of FASB Interpretation No. 9)*. With the issuance of Statement 147, the provisions of Statement 72 are no longer relevant to the accounting for such transactions.

12. Topic 12: Oil and Gas Producing Activities

a. Topic 12.A.1 is revised to delete, in the interpretive response to question 3, the reference to Item 2(b)(3) of Regulation S–K, which has been redesignated within Industry Guide 2.

b. Topic 12.A.2 is revised to update the references to the required disclosures of the standardized measure of discounted future net cash flows to the provisions of Statement 69, *Disclosures about Oil and Gas Producing Activities*. Consistent with this change, reference to "standardized measure of discounted future net cash flows" is substituted for "estimated future net revenues" and "year end prices" substituted for "current prices" for consistency with the terminology used in Statement 69. Furthermore, questions 4–11, and the related

interpretive responses to those questions which deal with the reporting implications of the Windfall Profits Tax and the 1985 natural gas price decontrol and disclosure of reserve information are deleted as no longer being relevant.

c. Topic 12 A.3.a is deleted. The required disclosures of the standardized measure of discounted future net cash flows is provided by Statement 69 and the guidance is no longer necessary.

d. Topic 12.A.3.c is revised to update the references to the required disclosures of the standardized measure of discounted future net cash flows to the provisions of Statement 69.

e. Topic 12.A.3.d is revised to update the references to the required disclosures of the standardized measure of discounted future net cash flows to the provisions of Statement 69.

f. Topic 12.A.4, regarding filings by Canadian registrants, is deleted as no longer being relevant.

g. Topic 12.B regarding supplemental disclosures on the basis of reserve recognition accounting is deleted as no longer being relevant.

h. Topic 12.C.2 is revised to update the references currently included in Regulation S-X.

i. Topic 12.D.1 is revised to update the references currently included in Regulation S-X.

j. Topic 12.D.2 is revised to update the references to the required disclosures of the standardized measure of discounted future net cash flows to the provisions of Statement 69.

k. Topic 12.D.3.a is revised to update the references currently included in Regulation S-X.

l. Topic 12.D.3.b is redesignated as Topic 12.D.3.c and revised to provide updated guidance consistent with Statement 133.

m. Topic 12.D.3.b is rewritten to reflect the changes in the computation as a result of changes in the authoritative literature related to derivatives accounted for in accordance with Statement 133.

n. Topic 12.F is revised to substitute the reference to Rule 4-10(c)(3)(iii) of Regulation S-X for outdated Rule 4-10(i)(3)(iii) of Regulation S-X.

o. Topic 12.G is revised to update the references to the required disclosures of the standardized measure of discounted future net cash flows to the provisions of Statement 69 and to substitute the reference to Rule 4-10(c)(4) of Regulation S-X for Rule 4-10(k)(4) of Regulation S-X.

13. Topic 13: Revenue Recognition

a. Topic 13.A.3, the following changes are made:

i. The interpretive response to question 3 is modified to incorporate

the guidance on separate elements of an arrangement from EITF Issue 00-21. Additionally, footnote 24 is modified to remove the reference to Statement 53, *Financial Reporting by Producers and Distributors of Motion Picture Films*, which has been superseded and to add a reference to SOP 00-2, *Accounting by Producers or Distributors of Films*.

ii. The interpretive response to question 7 is modified to refer to Statement 140 which replaced Statement 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

b. Topic 13.B, footnote 6 is modified to refer to SAS 99 which superseded SAS 82.

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Topic 1: Financial Statements

A. Target Companies

Facts: Company X proposes to file a registration statement covering an exchange offer to stockholders of Company Y, a publicly held company. Company X asks Company Y to furnish information about its business, including current audited financial statements, for inclusion in the prospectus. Company Y declines to furnish such information.

Question 1: In filing the registration statement without the required information about Company Y, may Company X rely on Rule 409 in that the information is “unknown or not reasonably available?”

Interpretive Response: Yes, but to determine whether such reliance is justified, the staff requests the registrant to submit as supplemental information copies of correspondence between the registrant and the target company evidencing the request for and the refusal to furnish the financial statements. In addition, the prospectus must include any financial statements which are relevant and available from the Commission’s public files and must contain a statement adequately describing the situation and the sources of information about the target company. Other reliable sources of financial information should also be utilized.

Question 2: Would the response change if Company Y was a closely held company?

Interpretive Response: Yes. The staff does not believe that Rule 409 is applicable to negotiated transactions of this type.

B. Allocation of Expenses and Related Disclosure in Financial Statements of Subsidiaries, Divisions or Lesser Business Components of Another Entity

Facts: A company (the registrant) operates as a subsidiary of another company (parent). Certain expenses incurred by the parent on behalf of the subsidiary have not been charged to the subsidiary in the past. The subsidiary files a registration statement under the Securities Act of 1933 in connection with an initial public offering.

1. Costs Reflected in Historical Financial Statements

Question 1: Should the subsidiary’s historical income statements reflect all of the expenses that the parent incurred on its behalf?

Interpretive Response: In general, the staff believes that the historical income statements of a registrant should reflect all of its costs of doing business. Therefore, in specific situations, the staff has required the subsidiary to revise its financial statements to include certain expenses incurred by the parent on its behalf. Examples of such expenses may include, but are not necessarily limited to, the following (income taxes and interest are discussed separately below):

1. Officer and employee salaries,
2. Rent or depreciation,
3. Advertising,
4. Accounting and legal services, and
5. Other selling, general and administrative expenses.

When the subsidiary’s financial statements have been previously reported on by independent accountants and have been used other than for internal purposes, the staff has accepted a presentation that shows income before tax as previously reported, followed by adjustments for expenses not previously allocated, income taxes, and adjusted net income.

Question 2: How should the amount of expenses incurred on the subsidiary’s behalf by its parent be determined, and what disclosure is required in the financial statements?

Interpretive Response: The staff expects any expenses clearly applicable to the subsidiary to be reflected in its income statements. However, the staff understands that in some situations a reasonable method of allocating common expenses to the subsidiary (e.g., incremental or proportional cost allocation) must be chosen because specific identification of expenses is not practicable. In these situations, the staff has required an explanation of the allocation method used in the notes to the financial statements along with

management’s assertion that the method used is reasonable.

In addition, since agreements with related parties are by definition not at arms length and may be changed at any time, the staff has required footnote disclosure, when practicable, of management’s estimate of what the expenses (other than income taxes and interest discussed separately below) would have been on a stand alone basis, that is, the cost that would have been incurred if the subsidiary had operated as an unaffiliated entity. The disclosure has been presented for each year for which an income statement was required when such basis produced materially different results.

Question 3: What are the staff’s views with respect to the accounting for and disclosure of the subsidiary’s income tax expense?

Interpretive Response: Recently, a number of parent companies have sold interests in subsidiaries, but have retained sufficient ownership interests to permit continued inclusion of the subsidiaries in their consolidated tax returns. The staff believes that it is material to investors to know what the effect on income would have been if the registrant had not been eligible to be included in a consolidated income tax return with its parent. Some of these subsidiaries have calculated their tax provision on the separate return basis, which the staff believes is the preferable method. Others, however, have used different allocation methods. When the historical income statements in the filing do not reflect the tax provision on the separate return basis, the staff has required a pro forma income statement for the most recent year and interim period reflecting a tax provision calculated on the separate return basis.¹

Question 4: Should the historical income statements reflect a charge for interest on intercompany debt if no such charge had been previously provided?

Interpretive Response: The staff generally believes that financial statements are more useful to investors if they reflect all costs of doing business, including interest costs. Because of the inherent difficulty in distinguishing the elements of a subsidiary’s capital structure, the staff has not insisted that

¹ Paragraph 40 of Statement 109 states: “The consolidated amount of current and deferred tax expense for a group that files a consolidated tax return shall be allocated among the members of the group when those members issue separate financial statements. * * * The method adopted * * * shall be systematic, rational, and consistent with the broad principles established by [Statement 109]. A method that allocates current and deferred taxes to members of the group by applying [Statement 109] to each member as if it were a separate taxpayer meets those criteria.”

the historical income statements include an interest charge on intercompany debt if such a charge was not provided in the past, except when debt specifically related to the operations of the subsidiary and previously carried on the parent's books will henceforth be recorded in the subsidiary's books. In any case, financing arrangements with the parent must be discussed in a note to the financial statements. In this connection, the staff has taken the position that, where an interest charge on intercompany debt has not been provided, appropriate disclosure would include an analysis of the intercompany accounts as well as the average balance due to or from related parties for each period for which an income statement is required. The analysis of the intercompany accounts has taken the form of a listing of transactions (e.g., the allocation of costs to the subsidiary, intercompany purchases, and cash transfers between entities) for each period for which an income statement was required, reconciled to the intercompany accounts reflected in the balance sheets.

2. Pro Forma Financial Statements and Earnings per Share

Question: What disclosure should be made if the registrant's historical financial statements are not indicative of the ongoing entity (e.g., tax or other cost sharing agreements will be terminated or revised)?

Interpretive Response: The registration statement should include pro forma financial information that is in accordance with Article 11 of Regulation S-X and reflects the impact of terminated or revised cost sharing agreements and other significant changes.

3. Other Matters

Question: What is the staff's position with respect to dividends declared by the subsidiary subsequent to the balance sheet date?

Interpretive Response: The staff believes that such dividends either be given retroactive effect in the balance sheet with appropriate footnote disclosure, or reflected in a pro forma balance sheet. In addition, when the dividends are to be paid from the proceeds of the offering, the staff believes it is appropriate to include pro forma per share data (for the latest year and interim period only) giving effect to the number of shares whose proceeds were to be used to pay the dividend. A similar presentation is appropriate when dividends exceed earnings in the current year, even though the stated use of proceeds is other than for the

payment of dividends. In these situations, pro forma per share data should give effect to the increase in the number of shares which, when multiplied by the offering price, would be sufficient to replace the capital in excess of earnings being withdrawn.

C. Unaudited Financial Statements for a Full Fiscal Year

Facts: Company A, which is a reporting company under the Securities Exchange Act of 1934, proposes to file a registration statement within 90 days of its fiscal year end but does not have audited year-end financial statements available. The company meets the criteria under Rule 3-01(c) of Regulation S-X and is therefore not required to include year-end audited financial statements in its registration statement. However, the Company does propose to include in the prospectus the unaudited results of operations for its entire fiscal year.

Question: Would the staff find this objectionable?

Interpretive Response: The staff recognizes that many registrants publish the results of their most recent year's operations prior to the availability of year-end audited financial statements. The staff will not object to the inclusion of unaudited results for a full fiscal year and indeed would expect such data in the registration statement if the registrant has published such information. When such data is included in a prospectus, it must be covered by a management's representation that all adjustments necessary for a fair statement of the results have been made.

D. Foreign Companies

1. Disclosures Required of Companies Complying With Item 17 of Form 20-F

Facts: A foreign private issuer may use Form 20-F as a registration statement under section 12 or as an annual report under section 13(a) or 15(d) of the Exchange Act. The registrant must furnish the financial statements specified in Item 17 of that form. However, in certain circumstances, Forms F-3 and F-2 require that the annual report include financial statements complying with Item 18 of the form. Also, financial statements complying with Item 18 are required for registration of securities under the Securities Act in most circumstances. Item 17 permits the registrant to use its financial statements that are prepared on a comprehensive basis other than U.S. GAAP, but requires quantification of the material differences in the principles, practices

and methods of accounting. An issuer complying with Item 18 must satisfy the requirements of Item 17 and also must provide all other information required by U.S. GAAP and Regulation S-X.

Question: Assuming that the registrant's financial statements include a discussion of material variances from U.S. GAAP along with quantitative reconciliations of net income and material balance sheet items, does Item 17 of Form 20-F require other disclosures in addition to those prescribed by the standards and practices which comprise the comprehensive basis on which the registrant's primary financial statements are prepared?

Interpretive Response: No. The distinction between Items 17 and 18 is premised on a classification of the requirements of U.S. GAAP and Regulation S-X into those that specify the methods of measuring the amounts shown on the face of the financial statements and those prescribing disclosures that explain, modify or supplement the accounting measurements. Disclosures required by U.S. GAAP but not required under the foreign GAAP on which the financial statements are prepared need not be furnished pursuant to Item 17.

Notwithstanding the absence of a requirement for certain disclosures within the body of the financial statements, some matters routinely disclosed pursuant to U.S. GAAP may rise to a level of materiality such that their disclosure is required by Item 5 (Management's Discussion and Analysis) of Form 20-F. Among other things, this item calls for a discussion of any known trends, demands, commitments, events or uncertainties that are reasonably likely to affect liquidity, capital resources or the results of operations in a material way. Also, instruction 2 of this item requires "a discussion of any aspects of the differences between foreign and U.S. GAAP, not discussed in the reconciliation, that the registrant believes is necessary for an understanding of the financial statements as a whole." Matters that may warrant discussion in response to Item 5 include the following:

- Material undisclosed uncertainties (such as reasonably possible loss contingencies), commitments (such as those arising from leases), and credit risk exposures and concentrations;
- Material unrecognized obligations (such as pension obligations);
- Material changes in estimates and accounting methods, and other factors or events affecting comparability;

- Defaults on debt and material restrictions on dividends or other legal constraints on the registrant's use of its assets;
- Material changes in the relative amounts of constituent elements comprising line items presented on the face of the financial statements;
- Significant terms of financings which would reveal material cash requirements or constraints;
- Material subsequent events, such as events that affect the recoverability of recorded assets;
- Material related party transactions (as addressed by Statement 57) that may affect the terms under which material revenues or expenses are recorded; and
- Significant accounting policies and measurement assumptions not disclosed in the financial statements, including methods of costing inventory, recognizing revenues, and recording and amortizing assets, which may bear upon an understanding of operating trends or financial condition.

2. "Free Distributions" by Japanese Companies

Facts: It is the general practice in Japan for corporations to issue "free distributions" of common stock to existing shareholders in conjunction with offerings of common stock so that such offerings may be made at less than market. These free distributions usually are from 5 to 10 percent of outstanding stock and are accounted for in accordance with provisions of the Commercial Code of Japan by a transfer of the par value of the stock distributed from paid-in capital to the common stock account. Similar distributions are sometimes made at times other than when offering new stock and are also designated "free distributions." U.S. accounting practice would require that the fair value of such shares, if issued by U.S. companies, be transferred from retained earnings to the appropriate capital accounts.

Question: Should the financial statements of Japanese corporations included in Commission filings which are stated to be prepared in accordance with U.S. GAAP be adjusted to account for stock distributions of less than 25 percent of outstanding stock by transferring the fair value of such stock from retained earnings to appropriate capital accounts?

Interpretive Response: If registrants and their independent accountants believe that the institutional and economic environment in Japan with respect to the registrant is sufficiently different that U.S. accounting principles for stock dividends should not apply to free distributions, the staff will not

object to such distributions being accounted for at par value in accordance with Japanese practice. If such financial statements are identified as being prepared in accordance with U.S. GAAP, then there should be footnote disclosure of the method being used which indicates that U.S. companies issuing shares in comparable amounts would be required to account for them as stock dividends, and including in such disclosure the fair value of any such shares issued during the year and the cumulative amount (either in an aggregate figure or a listing of the amounts by year) of the fair value of shares issued over time.

E. Requirements for Audited or Certified Financial Statements

1. Deleted by SAB 103

2. Qualified Auditors' Opinions

Facts: The accountants' report is qualified as to scope of audit, or the accounting principles used.

Question: Does the staff consider the requirements for audited or certified financial statements met when the auditors' opinion is so qualified?

Interpretive Response: No. The staff does not accept as consistent with the requirements of Rule 2-02(b) of Regulation S-X financial statements on which the auditors' opinions are qualified because of a limitation on the scope of the audit, since in these situations the auditor was unable to perform all the procedures required by professional standards to support the expression of an opinion. This position was discussed in ASR 90 in connection with representations concerning the verification of prior years' inventories in first audits.

Financial statements for which the auditors' opinions contain qualifications relating to the acceptability of accounting principles used or the completeness of disclosures made are also unacceptable. (See ASR 4, and with respect to a "going concern" qualification, ASR 115.)

F. Financial Statement Requirements in Filings Involving the Formation of a One-Bank Holding Company

Facts: Holding Company A is organized for the purpose of issuing common stock to acquire all of the common stock of Bank A. Under the plan of reorganization, each share of common stock of Bank A will be exchanged for one share of common stock of the holding company. The shares of the holding company to be issued in the transaction will be registered on Form S-4. The holding company will not engage in any

operations prior to consummation of the reorganization, and its only significant asset after the transaction will be its investment in the bank. The bank has been furnishing its shareholders with an annual report that includes financial statements that comply with GAAP.

Item 14 of Schedule 14A of the proxy rules provides that financial statements generally are not necessary in proxy material relating only to changes in legal organization (such as reorganizations involving the issuer and one or more of its totally held subsidiaries).

Question 1: Must the financial statements and the information required by Securities Act Industry Guide ("Guide 3")¹ for Bank A be included in the initial registration statement on Form S-4?

Interpretive Response: No, provided that certain conditions are met. The staff will not take exception to the omission of financial statements and Guide 3 information in the initial registration statement on Form S-4 if all of the following conditions are met:

- There are no anticipated changes in the shareholders' relative equity ownership interest in the underlying bank assets, except for redemption of no more than a nominal number of shares of unaffiliated persons who dissent;

- In the aggregate, only nominal borrowings are to be incurred for such purposes as organizing the holding company, to pay nonaffiliated persons who dissent, or to meet minimum capital requirements;

- There are no new classes of stock authorized other than those corresponding to the stock of Bank A immediately prior to the reorganization;

- There are no plans or arrangements to issue any additional shares to acquire any business other than Bank A; and

- There has been no material adverse change in the financial condition of the bank since the latest fiscal year-end included in the annual report to shareholders.

If at the time of filing the S-4, a letter is furnished to the staff stating that all of these conditions are met, it will not be necessary to request the Division of Corporation Finance to waive the financial statement or Guide 3 requirements of Form S-4.

Although the financial statements may be omitted, the filing should include a section captioned, "Financial Statements," which states either that an annual report containing financial statements for at least the latest fiscal year prepared in conformity with GAAP was previously furnished to shareholders or is being delivered with

¹ Item 801 of Regulation S-K.

the prospectus. If financial statements have been previously furnished, it should be indicated that an additional copy of such report for the latest fiscal year will be furnished promptly upon request without charge to shareholders. The name and address of the person to whom the request should be made should be provided. One copy of such annual report should be furnished supplementally with the initial filing for purposes of staff review.

If any nominal amounts are to be borrowed in connection with the formation of the holding company, a statement of capitalization should be included in the filing which shows Bank A on an historical basis, the pro forma adjustments, and the holding company on a pro forma basis. A note should also explain the pro forma effect, in total and per share, which the borrowings would have had on net income for the latest fiscal year if the transaction had occurred at the beginning of the period.

Question 2: Are the financial statements of Bank A required to be audited for purposes of the initial Form S-4 or the subsequent Form 10-K report?

Interpretive Response: The staff will not insist that the financial statements in the annual report to shareholders used to satisfy the requirement of the initial Form S-4 be audited.

The consolidated financial statements of the holding company to be included in the registrant's initial report on Form 10-K should comply with the applicable financial statement requirements in Regulation S-X at the time such annual report is filed. However, the regulations also provide that the staff may allow one or more of the required statements to be unaudited where it is consistent with the protection of investors.² Accordingly, the policy of the Division of Corporation Finance is as follows:

- The registrant should file audited balance sheets as of the two most recent fiscal years and audited statements of income and cash flows for each of the three latest fiscal years, with appropriate footnotes and schedules as required by Regulation S-X unless the financial statements have not previously been audited for the periods required to be filed. In such cases, the Division will not object if the financial statements in the first annual report on Form 10-K (or the special report filed pursuant to Rule 15d-2)³ are audited only for the two

latest fiscal years.⁴ This policy only applies to filings on Form 10-K, and not to any Securities Act filings made after the initial S-4 filing.

The above procedure may be followed without making a specific request of the Division of Corporation Finance for a waiver of the financial statement requirements of Form 10-K.

The information required by Guide 3 should also be provided in the Form 10-K for at least the periods for which audited financial statements are furnished. If some of the statistical information for the two most recent fiscal years for which audited financial statements are included (other than information on nonperforming loans and the summary of loan loss experience) is unavailable and cannot be obtained without unwarranted or undue burden or expense, such data may be omitted provided a brief explanation in support of such representation is included in the report on Form 10-K. In all cases, however, information with respect to nonperforming loans and loan loss experience, or reasonably comparable data, must be furnished for at least the two latest fiscal years in the initial 10-K. Thereafter, for subsequent years in reports on Form 10-K, all of the Guide 3 information is required; Guide 3 information which had been omitted in the initial 10-K in accordance with the above procedure can be excluded in any subsequent 10-Ks.

G. Deleted by FRR 55

H. Deleted by FRR 55

I. Financial Statements of Properties Securing Mortgage Loans

Facts: A registrant files a Securities Act registration statement covering a maximum of \$100 million of securities. Proceeds of the offering will be used to make mortgage loans on operating residential or commercial property. Proceeds of the offering will be placed in escrow until \$1 million of securities are sold at which point escrow may be broken, making the proceeds immediately available for lending, while the selling of securities would continue.

Question 1: Under what circumstances are the financial statements of a property on which the registrant makes or expects to make a loan required to be included in a filing?

Interpretive Response: Rule 3-14 of Regulation S-X specifies the

situation, Rule 15d-2 would require the registrant to file a special report within 90 days after the effective date of the Form S-4 furnishing audited financial statements for the most recent fiscal year.

⁴ Unaudited statements of income and cash flows should be furnished for the earliest period.

requirements for financial statements when the registrant has acquired one or more properties which in the aggregate are significant, or since the date of the latest balance sheet required has acquired or proposes to acquire one or more properties which in the aggregate are significant.

Included in the category of properties acquired or to be acquired under Rule 3-14 are operating properties underlying certain mortgage loans, which in economic substance represent an investment in real estate or a joint venture rather than a loan. Certain characteristics of a lending arrangement indicate that the "lender" has the same risks and potential rewards as an owner or joint venturer. Those characteristics are set forth in Exhibit I to the Appendix of the American Institute of Certified Public Accountants' Practice Bulletin 1¹ "ADC² Arrangements" ("Exhibit I to PB1"). In September 1986 the EITF³ reached a consensus on this issue⁴ to the effect that, although Exhibit I to PB1 was issued to address the real estate ADC arrangements of financial institutions, preparers and auditors should consider the guidance contained in Exhibit I to PB1 in accounting for shared appreciation mortgages, loans on operating real estate and real estate ADC arrangements entered into by enterprises other than financial institutions.

Statement 133 as amended by Statements 137 and 138, generally requires that embedded instruments meeting the definition of a derivative and not clearly and closely related to the host contract be accounted for separately from the host instrument. If the embedded the expected residual profit component of an ADC arrangement need not be separately accounted for as a derivative under Statement 133, then the disclosure requirements discussed below for ADC loans and similar arrangements should be followed.⁵

¹ "ADC Arrangements" was originally issued as a notice to practitioners (February 1986, as published in the April 1986 issue of the Journal of Accountancy). The notice to practitioners was reprinted without change as Exhibit I to the Appendix of the American Institute of Certified Public Accountants' Practice Bulletin 1 (November 1987).

² Acquisition, development and construction.

³ The Emerging Issues Task Force ("EITF") was formed in 1984 to assist the Financial Accounting Standards Board in the early identification and resolution of emerging accounting issues. Topics to be discussed by the EITF are publicly announced prior to its meetings and minutes of all EITF meetings are available to the public.

⁴ See Issue 86-21.

⁵ The equity kicker (the expected residual profit) would typically not be separated from the host contract and accounted for as a derivative because

² Rule 3-13 of Regulation S-X.

³ Rule 15d-2 would be applicable if the annual report furnished with the Form S-4 was not for the registrant's most recent fiscal year. In such a

In certain cases the “lender” has virtually the same potential rewards as those of an owner or a joint venturer by virtue of participating in expected residual profit.⁶ In addition, Exhibit I to PB1 includes a number of other characteristics which, when considered individually or in combination, would suggest that the risks of an ADC arrangement are similar to those associated with an investment in real estate or a joint venture or, conversely, that they are similar to those associated with a loan. Among those other characteristics is whether the lender agrees to provide all or substantially all necessary funds to acquire the property, resulting in the borrower having title to, but little or no equity in, the underlying property. The staff believes that the borrower’s equity in the property is adequate to support accounting for the transaction as a mortgage loan when the borrower’s initial investment meets the criteria in paragraph 11 of Statement 66⁷ and the borrower’s payments of principal and interest on the loan are adequate to maintain a continuing investment in the property which meets the criteria in paragraph 12 of Statement 66.⁸

The financial statements of properties which will secure mortgage loans made or to be made from the proceeds of the offering which have the characteristics of real estate investments or joint ventures should be included as required by Rule 3–14 in the registration statement when such properties secure loans previously made, or have been identified as security for probable loans prior to effectiveness, and in filings

paragraph 12(c) of Statement 133 exempts a hybrid contract from bifurcation if a separate instrument with the same terms as the embedded equity kicker is not a derivative instrument subject to the requirements of Statement 133.

⁶ Expected residual profit is defined in Exhibit I to PB1 as the amount of profit, whether called interest or another name, such as equity kicker, above a reasonable amount of interest and fees expected to be earned by the “lender.”

⁷ Statement 66 establishes standards for the recognition of profit on real estate sales transactions. Paragraph 11 states that the buyer’s initial investment shall be adequate to demonstrate the buyer’s commitment to pay for the property and shall indicate a reasonable likelihood that the seller will collect the receivable. Guidance on minimum initial investments in various types of real estate is provided in paragraphs 53 and 54 of Statement 66.

⁸ Paragraph 12 of Statement 66 states that the buyer’s continuing investment in a real estate transaction shall not qualify unless the buyer is contractually required to pay each year on its total debt for the purchase price of the property an amount at least equal to the level annual payment that would be needed to pay that debt and interest on the unpaid balance over not more than (a) 20 years for debt for land and (b) the customary amortization term of a first mortgage loan by an independent established lending institution for other real estate.

made pursuant to the undertaking in Item 20D of Securities Act Industry Guide 5.

Rule 1–02(w) of Regulation S–X includes the conditions used in determining whether an acquisition is significant. The separate financial statements of an individual property should be provided when a property would meet the requirements for a significant subsidiary under this rule using the amount of the “loan” as a substitute for the “investment in the subsidiary” in computing the specified conditions. The combined financial statements of properties which are not individually significant should also be provided. However, the staff will not object if the combined financial statements of such properties are not included if none of the conditions specified in Rule 1–02(w), with respect to all such properties combined, exceeds 20% in the aggregate.

Under certain circumstances, information may also be required regarding operating properties underlying mortgage loans where the terms do not result in the lender having virtually the same risks and potential rewards as those of owners or joint venturers. Generally, the staff believes that, where investment risks exist due to substantial asset concentration, financial and other information should be included regarding operating properties underlying a mortgage loan that represents a significant amount of the registrant’s assets. Such presentation is consistent with Rule 3–13 of Regulation S–X and Rule 408 under the Securities Act of 1933.

Where the amount of a loan exceeds 20% of the amount in good faith expected to be raised in the offering, disclosures would be expected to consist of financial statements for the underlying operating properties for the periods contemplated by Rule 3–14. Further, where loans on related properties are made to a single person or group of affiliated persons which in the aggregate amount to more than 20% of the amount expected to be raised, the staff believes that such lending arrangements result in a sufficient concentration of assets so as to warrant the inclusion of financial and other information regarding the underlying properties.

Question 2: Will the financial statements of the mortgaged properties be required in filings made under the 1934 Act?

Interpretive Response: Rule 3–09 of Regulation S–X specifies the requirement for significant, as defined, investments in operating entities, the operations of which are not included in

the registrant’s consolidated financial statements.⁹ Accordingly, the staff believes that the financial statements of properties securing significant loans which have the characteristics of real estate investments or joint ventures should be included in subsequent filings as required by Rule 3–09. The materiality threshold for determining whether such an investment is significant is the same as set forth in paragraph (a) of that Rule.¹⁰

Likewise, the staff believes that filings made under the 1934 Act should include the same financial and other information relating to properties underlying any loans which are significant as discussed in the last paragraph of Question 1, except that in the determination of significance the 20% disclosure threshold should be measured using total assets. The staff believes that this presentation would be consistent with Rule 12b–20 under the Securities Exchange Act of 1934.

Question 3: The interpretive response to question 1 indicates that the staff believes that the borrower’s equity in an operating property is adequate to support accounting for the transaction as a mortgage loan when the borrower’s initial investment meets the criteria in paragraph 11 of Statement 66 and the borrower’s payments of principal and interest on the loan are adequate to maintain a continuing investment in the property which meets the criteria in paragraph 12 of Statement 66. Is it the staff’s view that meeting these criteria is the only way the borrower’s equity in the property is considered adequate to support accounting for the transaction as a mortgage loan?

Interpretive Response: No. It is the staff’s position that the determination of whether loan accounting is appropriate for these arrangements should be made by the registrant and its independent accountants based on the facts and circumstances of the individual arrangements, using the guidance

⁹ Rule 3–14 states that the financial statements of an acquired property should be furnished if the acquisition took place during the period for which the registrant’s income statements are required. Paragraph (b) of the Rule states that the information required by the Rule is not required to be included in a filing on Form 10–K. That exception is consistent with Item 8 of Form 10–K which excludes acquired company financial statements, which would otherwise be required by Rule 3–05 of Regulation S–X, from inclusion in filings on that Form. Those exceptions are based, in part, on the fact that acquired properties and acquired companies will generally be included in the registrant’s consolidated financial statements from the acquisition date.

¹⁰ Rule 3–09(a) states, in part, that “[i]f any of the conditions set forth in [Rule] 1–02(w), substituting 20 percent for 10 percent in the tests used therein to determine significant subsidiary, are met * * * separate financial statements * * * shall be filed.”

provided in the Exhibit I to the Appendix of the American Institute of Certified Public Accountants Practice Bulletin 1 (November, 1987) ("Exhibit I to PB1"). As stated in Exhibit I to PB1, loan accounting may not be appropriate when the lender participates in expected residual profit and has virtually the same risks as those of an owner, or joint venturer. In assessing the question of whether the lender has virtually the same risks as an owner, or joint venturer, the essential test that needs to be addressed is whether the borrower has and is expected to continue to have a substantial amount at risk in the project.¹¹ The criteria described in Statement 66 provide a "safe harbor" for determining whether the borrower has a substantial amount at risk in the form of a substantial equity investment. The borrower may have a substantial amount at risk without meeting the criteria described in Statement 66.

Question 4: What financial statements should be included in filings made under the Securities Act regarding investment-type arrangements that individually amount to 10% or more of total assets?

Interpretive Response: In the staff's view, separate audited financial statements should be provided for any investment-type arrangement that constitutes 10% or more of the greater of (i) the amount of minimum proceeds or (ii) the total assets of the registrant, including the amount of proceeds raised, as of the date the filing is required to be made. Of course, the narrative information required by items 14 and 15 of Form S-11 should also be included with respect to these investment-type arrangements.

Question 5: What information must be provided under the Securities Act for investment-type arrangements that individually amount to less than 10%?

Interpretive Response: No specific financial information need be presented for investment-type arrangements that amount to less than 10%. However, where such arrangements aggregate more than 20%, a narrative description of the general character of the properties and arrangements should be included that gives an investor an understanding of the risks and rewards associated with

these arrangements. Such information may, for example, include a description of the terms of the arrangements, participation by the registrant in expected residual profits, and property types and locations.

Question 6: What financial statements should be included in annual reports filed under the Exchange Act with respect to investment-type arrangements that constitute 10% or more of the registrant's total assets?

Interpretive Response: In annual reports filed with the Commission, the staff has advised registrants that separate audited financial statements should be provided for each nonconsolidated investment-type arrangement that is 20% or more of the registrant's total assets. While the distribution is on-going, however, the percentage may be calculated using the greater of (i) the amount of the minimum proceeds or (ii) the total assets of the registrant, including the amount of proceeds raised, as of the date the filing is required to be made. In annual reports to shareholders registrants may either include the separate audited financial statements for 20% or more nonconsolidated investment-type arrangements or, if those financial statements are not included, present summarized financial information for those arrangements in the notes to the registrant's financial statements.

The staff has also indicated that separate summarized financial information (as defined in Rule 1-02(bb) of Regulation S-X) should be provided in the footnotes to the registrant's financial statements for each nonconsolidated investment-type arrangement that is 10% or more but less than 20%. Of course, registrants should also make appropriate textual disclosure with respect to material investment-type arrangements in the "business" and "property" sections of their annual reports to the Commission.¹²

Question 7: What information should be provided in annual reports filed under the Exchange Act with respect to investment-type arrangements that do not meet the 10% threshold?

Interpretive Response: The staff believes it will not be necessary to provide any financial information (full or summarized) for investment-type arrangements that do not meet the 10% threshold. However, in the staff's view,

where such arrangements aggregate more than 20%, a narrative description of the general character of the properties and arrangements would be necessary. The staff believes that information should be included that would give an investor an understanding of the risks and rewards associated with these arrangements. Such information may, for example, include a description of the terms of the arrangements, participation by the registrant in expected residual profits, and property types and locations. Of course, disclosure regarding the operations of such components should be included as part of the Management's Discussion and Analysis where there is a known trend or uncertainty in the operations of such properties, either individually or in the aggregate, which would be reasonably likely to result in a material impact on the registrant's future operations, liquidity or capital resources.

J. Application of Rule 3-05 in Initial Public Offerings

Facts: Rule 3-05 of Regulation S-X establishes the financial statement requirements for businesses acquired or to be acquired. If required, financial statements must be provided for one, two or three years depending upon the relative significance of the acquired entity as determined by the application of Rule 1-02(w) of Regulation S-X. The calculations required for these tests are applied by comparison of the financial data of the registrant and acquiree(s) for the fiscal years most recently completed prior to the acquisition. The staff has recognized that these tests literally applied in some initial public offerings may require financial statements for an acquired entity which may not be significant to investors because the registrant has had substantial growth in assets and earnings in recent years.¹

Question: How should Rules 3-05 and 1-02(w) of Regulation S-X be applied in determining the periods for which financial statements of acquirees are required to be included in registration statements for initial public offerings?

Interpretive Response: It is the staff's view that initial public offerings involving businesses that have been built by the aggregation of discrete businesses that remain substantially intact after acquisition² were not

¹¹ Regarding the composition of the borrower's investment, paragraph 9b of Exhibit I to PB1 indicates that the borrower's investment may include the value of land or other assets contributed by the borrower, net of encumbrances. The staff emphasizes that such paragraph indicates, " * * * recently acquired property generally should be valued at no higher than cost * * *". Thus, for such recently acquired property, appraisals will not be sufficient to justify the use of a value in excess of cost.

¹² Registrants are reminded that in filings on Form 8-K that are triggered in connection with an acquisition of an investment-type arrangement, separate audited financial statements are required for any such arrangement that individually constitutes 10% or more.

¹ An acquisition which was relatively significant in the earliest year for which a registrant is required to file financial statements may be insignificant to its latest fiscal year due to internal growth and/or subsequent acquisitions. Literally applied, Rules 3-05 and 1-02(w) might still require separate financial statements for the now insignificant acquisition.

² For example, nursing homes, hospitals or cable TV systems. This interpretation would not apply to

contemplated during the drafting of Rule 3-05 and that the significance of an acquired entity in such situations may be better measured in relation to the size of the registrant at the time the registration statement is filed, rather than its size at the time the acquisition was made. Therefore, for a first time registrant, the staff has indicated that in applying the significance tests in Rule 3-05, the three tests in Rule 1-02(w) generally can be measured against the combined entities, including those to be acquired, which comprise the registrant at the time the registration statement is filed. The staff's policy is intended to ensure that the registration statement will include not less than three, two and one year(s) of audited financial statements for not less than 60%, 80% and 90%, respectively, of the constituent businesses that will comprise the registrant on an ongoing basis. In all circumstances, the audited financial statements of the registrant are required for three years, or since its inception if less than three years. The requirement to provide the audited financial statements of a constituent business in the registration statement is satisfied for the post-acquisition period by including the entity's results in the

audited consolidated financial statements of the registrant. If additional periods are required, the entity's separate audited financial statements for the immediate pre-acquisition period(s) should be presented.³ In order for the pre-acquisition audited financial statements of an acquiree to be omitted from the registration statement, the following conditions must be met:

a. The combined significance of businesses acquired or to be acquired for which audited financial statements cover a period of less than 9 months⁴ may not exceed 10%;

b. The combined significance of businesses acquired or to be acquired for which audited financial statements cover a period of less than 21 months may not exceed 20%; and

c. The combined significance of businesses acquired or to be acquired for which audited financial statements cover a period of less than 33 months may not exceed 40%.

Combined significance is the total, for all included companies, of each individual company's highest level of significance computed under the three tests of significance. The significance tests should be applied to pro forma financial statements of the registrant, prepared in a manner consistent with

Article 11 of Regulation S-X. The pro forma balance sheet should be as of the date of the registrant's latest balance sheet included in the registration statement, and should give effect to businesses acquired subsequent to the end of the latest year or to be acquired as if they had been acquired on that date. The pro forma statement of operations should be for the registrant's most recent fiscal year included in the registration statement and should give effect to all acquisitions consummated during and subsequent to the end of the year and probable acquisitions as if they had been consummated at the beginning of that fiscal year.

The three tests specified in Rule 1-02(w) should be made in comparison to the registrant's pro forma consolidated assets and pretax income from continuing operations. The assets and pretax income of the acquired businesses which are being evaluated for significance should reflect any new cost basis arising from purchase accounting.

Example: On February 20, 20X9 Registrant files Form S-1 containing its audited consolidated financial statements as of and for the three years ended December 31, 20X8. Acquisitions since inception have been:

Acquiree	Fiscal year end	Date of acquisition	Highest significance at acquisition (percent)
A	3/31	1/1/x7	60
B	7/31	4/1/x7	45
C	9/30	9/1/x7	40
D	12/31	2/1/x8	21
E	3/31	11/1/x8	11
F	12/31	To be acquired	11

The following table reflects the application of the significance tests to the combined financial information at

the time the registration statement is filed.

Component entity	Assets (percent)	Significance of earnings (percent)	Investment (percent)	Highest level of significance (percent)
A	12	23	12	23
B	10	21	10	21
C	21	3	4	21
D	10	5	13	13
E	4	19	3	9
F	2	11	6	11

¹ Loss

businesses for which the relative significance of one portion of the business to the total business may be altered by post-acquisition decisions as to the allocation of incoming orders between plants or locations. This bulletin does not address all possible cases in which similar relief may be appropriate but, rather, attempts to describe a general framework within which administrative policy has been established. In other

distinguishable situations, registrants may request relief as appropriate to their individual facts and circumstances.

³ If audited pre-acquisition financial statements of a business are necessary pursuant to the alternative tests described here, the interim period following that entity's latest pre-acquisition fiscal year end but prior to its acquisition by the registrant generally would be required to be audited.

⁴ As a matter of policy the staff accepts financial statements for periods of not less than 9, 21 and 33 consecutive months (not more than 12 months may be included in any period reported on) as substantial compliance with requirements for financial statements for 1, 2 and 3 years, respectively.

Year 1 (most recent fiscal year)—Entity E is the only acquiree for which pre-acquisition financial statements may be omitted for the latest year since significance for each other entity exceeds 10% under one or more test.

Year 2 (preceding fiscal year)—Financial statements for E and F may be omitted since their combined significance is 20% and no other

combination can be formed with E which would not exceed 20%.

Year 3 (second preceding fiscal year)—Financial statements for D, E and F may be omitted since the combined significance of these entities is 33%⁵ and no other combination can be formed with E and F which would not exceed 40%.

The financial statement requirements must be satisfied by filing separate pre-acquisition audited financial statements for each entity that was not included in the consolidated financial statements for the periods set forth above. The following table illustrates the requirements for this example.

Component entity	Date of acquisition	Minimum financial statement requirement (months)	Period in consolidated financial statements (months)	Separate pre-acquisition audited financial statement (months)
Registrant	N/A	33	36	
A	1/1/x7	33	24	9
B	4/1/x7	33	21	⁶ 12
C	9/1/x7	33	16	17
D	2/1/x8	21	11	10
E	11/1/x8		2	
F	To be acquired	9		9

⁶ The audited pre-acquisition period need not correspond to the acquiree's pre-acquisition fiscal year. However, audited periods must not be for periods in excess of 12 months.

K. Financial Statements of Acquired Troubled Financial Institutions

Facts: Federally insured depository institutions are subject to regulatory oversight by various federal agencies including the Federal Reserve, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation and Office of Thrift Supervision. During the 1980s, certain of these institutions experienced significant financial difficulties resulting in their inability to meet necessary capital and other regulatory requirements. The Financial Institutions Reform, Recovery and Enforcement Act of 1989 was adopted to address various issues affecting this industry.

Many troubled institutions have merged into stronger institutions or reduced the scale of their operations through the sale of branches and other assets pursuant to recommendation or directives of the regulatory agencies. In other situations, institutions that were taken over by or operated under the management of a federal regulator have been reorganized, sold or transferred by that federal agency to financial and nonfinancial companies.

A number of registrants have acquired, or are contemplating acquisition of, these troubled financial institutions. Complete audited financial statements of the institutions for the periods necessary to comply fully with Rule 3-05 of Regulation S-X may not be

reasonably available in some cases. Some troubled institutions have never obtained an audit while others have been operated under receivership by regulators for a significant period without audit. Auditors' reports on the financial statements of some of these acquirees may not satisfy the requirements of Rule 2-02 of Regulation S-X because they contain qualifications due to audit scope limitations or disclaim an opinion.

A registrant that acquires a troubled financial institution for which complete audited financial statements are not reasonably available may be precluded from raising capital through a public offering of securities for up to three years following the acquisition because of the inability to comply with Rule 3-05.

Question 1: Are there circumstances under which the staff would conclude that financial statements of an acquired troubled financial institution are not required by Rule 3-05?

Interpretive Response: Yes. In some case, financial statements will not be required because there is not sufficient continuity of the acquired entity's operations prior to and after the acquisition, so that disclosure of prior financial information is material to an understanding of future operations, as discussed in Rule 11-01 of Regulation S-X. For example, such a circumstance may exist in the case of an acquisition solely of the physical facilities of a

banking branch with assumption of the related deposits if neither income-producing assets (other than treasury bills and similar low-risk investment) nor the management responsible for its historical investment and lending activities transfer with the branch to the registrant. In this and other circumstances, where the registrant can persuasively demonstrate that continuity of operations is substantially lacking and a representation to this effect is included in the filing, the staff will not object to the omission of financial statements. However, applicable disclosures specified by Industry Guide 3, Article 11 of Regulation S-X (pro forma information), and other information which is descriptive of the transaction and of the assets acquired and liabilities assumed should be furnished to the extent reasonably available.

Question 2: If the acquired financial institution is found to constitute a business having material continuity of operations after the transaction, are there circumstances in which the staff will waive the requirements of Rule 3-05?

Interpretive Response: Yes. The staff believes the circumstances surrounding the present restructuring of U.S. depository institutions are unique. Accordingly, the staff has identified situations in which it will grant a waiver of the requirements of Rule 3-05 of Regulation S-X to the extent that

⁵ Combined significance is the sum of the significance of D's investment test (13%), E's earnings test (9%) and F's earnings test (11%).

audited financial statements are not reasonably available.

For purposes of this waiver a "troubled financial institution" is one which either:

a. Is in receivership, conservatorship or is otherwise operating under a similar supervisory agreement with a federal financial regulatory agency; or

b. Is controlled by a federal regulatory agency; or

c. Is acquired in a federally assisted transaction.

A registrant that acquires a troubled financial institution that is deemed significant pursuant to Rule 3-05 may omit audited financial statements of the acquired entity, if such statements are not reasonably available and the total acquired assets of the troubled institution do not exceed 20% of the registrant's assets before giving effect to the acquisition. The staff will consider requests for waivers in situations involving more significant acquisitions, where federal financial assistance or guarantees are an essential part of the transaction, or where the nature and magnitude of federal assistance is so pervasive as to substantially reduce the relevance of such information to an assessment of future operations. Where financial statements are waived, disclosure concerning the acquired business as outlined in response to Question 3 must be furnished.

Question 3: Where historical financial statements meeting the requirements of Rule 3-05 of Regulation S-X are waived, what financial statements and other disclosures would the staff expect to be provided in filings with the Commission?

Interpretive Response: Where complete audited historical financial statements of a significant acquiree that is a troubled financial institution are not provided, the staff would expect filings to include an audited statement of assets acquired and liabilities assumed if the acquisition is not already reflected in the registrant's most recent audited balance sheet at the time the filing is made. Where reasonably available, unaudited statement of operations and cash flows that are prepared in accordance with GAAP and otherwise comply with Regulation S-X should be filed in lieu of any audited financial statements which are not provided if historical information may be relevant.

In all cases where a registrant succeeds to assets and/or liabilities of a troubled financial institution which are significant to the registrant pursuant to the tests in Rule 1-02(w) of Regulation S-X, narrative description should be required, quantified to the extent practicable, of the anticipated effects of

the acquisition on the registrant's financial condition, liquidity, capital resources and operating results. If federal financial assistance (including any commitments, agreements or understandings made with respect to capital, accounting or other forbearances) may be material, the limits, conditions and other variables affecting its availability should be disclosed, along with an analysis of its likely short term and long term effects on cash flows and reported results.

If the transaction will result in the recognition of any significant intangibles that cannot be separately sold, such as goodwill or a core deposit intangible, the discussion of the transaction should describe the amount of such intangibles, the necessarily subjective nature of the estimation of the life and value of such intangibles, and the effects upon future results of operations, liquidity and capital resources, including any consequences if a recognized intangible will be excluded from the calculation of capital for regulatory purposes. The discussion of the impact on future operations should specifically address the period over which intangibles will be amortized and the period over which any discounts on acquired assets will be taken into income. If amortization of intangibles will be over a period which differs from the period over which income from discounts on acquired assets will be recognized (whether from amortization of discounts or sale of discounted assets), disclosure should be provided concerning the disparate effects of the amortization and income recognition on operating results for all affected periods.

Information specified by Industry Guide 3 should be furnished to the extent applicable and reasonably available. For the categories identified in the Industry Guide, the registrant should disclose the carrying value of loans and investments acquired, as well as their principal amount and average contractual yield and term. Amounts of acquired investments, loans, or other assets that are nonaccrual, past due or restructured, or for which other collectibility problems are indicated should be disclosed. Where historical financial statements of the acquired entity are furnished, pro forma information presented pursuant to Rule 11-02 should be supplemented as necessary with a discussion of the likely effects of any federal assistance and changes in operations subsequent to the acquisition. To the extent historical financial statements meeting all the requirements of Rule 3-05 are not furnished, the filing should include an

explanation of the basis for their omission.

Question 4: If an audited statement of assets acquired and liabilities assumed is required, but certain of the assets conveyed in the transaction are subject to rights allowing the registrant to put the assets back to the seller upon completion of a due diligence review, will the staff grant an extension of time for filing the required financial statement until the put period lapses?

Interpretive Response: If it is impracticable to provide an audited statement at the time the Form 8-K reporting the transaction is filed, an extension of time is available under certain circumstances. Specifically, if more than 25% of the acquired assets may be put and the put period does not exceed 120 days, the registrant should timely file a statement of assets acquired and liabilities assumed on an unaudited basis with full disclosure of the terms and amounts of the put arrangement. Within 21 days after the put period lapses, the registrant should furnish an audited statement of assets acquired and liabilities assumed unless the effects of the transaction are already reflected in an audited balance sheet which has been filed with the Commission. However, until the audited financial statement has been filed, certain offerings under the Securities Act of 1933 would be prevented, as described in Instruction 1 to Item 7 of Form 8-K.

L. Deleted by SAB 103

M. Materiality

1. Assessing Materiality

Facts: During the course of preparing or auditing year-end financial statements, financial management or the registrant's independent auditor becomes aware of misstatements in a registrant's financial statements. When combined, the misstatements result in a 4% overstatement of net income and a \$.02 (4%) overstatement of earnings per share. Because no item in the registrant's consolidated financial statements is misstated by more than 5%, management and the independent auditor conclude that the deviation from GAAP is immaterial and that the accounting is permissible.¹

¹ AU 312 states that the auditor should consider audit risk and materiality both in (a) planning and setting the scope for the audit and (b) evaluating whether the financial statements taken as a whole are fairly presented in all material respects in conformity with GAAP. The purpose of this SAB is to provide guidance to financial management and independent auditors with respect to the evaluation of the materiality of misstatements that are identified in the audit process or preparation of the financial statements (*i.e.*, (b) above). This SAB is not

Question: Each Statement of Financial Accounting Standards adopted by the FASB states, "The provisions of this Statement need not be applied to immaterial items." In the staff's view, may a registrant or the auditor of its financial statements assume the immateriality of items that fall below a percentage threshold set by management or the auditor to determine whether amounts and items are material to the financial statements?

Interpretive Response: No. The staff is aware that certain registrants, over time, have developed quantitative thresholds as "rules of thumb" to assist in the preparation of their financial statements, and that auditors also have used these thresholds in their evaluation of whether items might be considered material to users of a registrant's financial statements. One rule of thumb in particular suggests that the misstatement or omission² of an item that falls under a 5% threshold is not material in the absence of particularly egregious circumstances, such as self-dealing or misappropriation by senior management. The staff reminds registrants and the auditors of their financial statements that exclusive reliance on this or any percentage or numerical threshold has no basis in the accounting literature or the law.

The use of a percentage as a numerical threshold, such as 5%, may provide the basis for a preliminary assumption that—without considering all relevant circumstances—a deviation of less than the specified percentage with respect to a particular item on the registrant's financial statements is unlikely to be material. The staff has no objection to such a "rule of thumb" as an initial step in assessing materiality. But quantifying, in percentage terms, the magnitude of a misstatement is only the beginning of an analysis of materiality; it cannot appropriately be used as a substitute for a full analysis of all relevant considerations. Materiality concerns the significance of an item to users of a registrant's financial statements. A matter is "material" if there is a substantial likelihood that a reasonable person would consider it important. In its Concepts Statement 2,

intended to provide definitive guidance for assessing "materiality" in other contexts, such as evaluations of auditor independence, as other factors may apply. There may be other rules that address financial presentation. See, e.g., Rule 2a-4, 17 CFR 270.2a-4, under the Investment Company Act of 1940.

² See, e.g., Rule 2a-4, 17 CFR 270.2a-4, under the Investment Company Act of 1940. As used in this SAB, "misstatement" or "omission" refers to a financial statement assertion that would not be in conformity with GAAP.

the FASB stated the essence of the concept of materiality as follows:

The omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.³

This formulation in the accounting literature is in substance identical to the formulation used by the courts in interpreting the federal securities laws. The Supreme Court has held that a fact is material if there is—

a substantial likelihood that the * * * fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.⁴

Under the governing principles, an assessment of materiality requires that one views the facts in the context of the "surrounding circumstances," as the accounting literature puts it, or the "total mix" of information, in the words of the Supreme Court. In the context of a misstatement of a financial statement item, while the "total mix" includes the size in numerical or percentage terms of the misstatement, it also includes the factual context in which the user of financial statements would view the financial statement item. The shorthand in the accounting and auditing literature for this analysis is that financial management and the auditor must consider both "quantitative" and "qualitative" factors in assessing an item's materiality.⁵ Court decisions, Commission rules and enforcement actions, and accounting and auditing literature⁶ have all considered "qualitative" factors in various contexts.

³ Concepts Statement 2, paragraph 132. See also Concepts Statement 2, Glossary of Terms—Materiality.

⁴ *TSC Industries v. Northway, Inc.*, 426 U.S. 438, 449 (1976). See also *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988). As the Supreme Court has noted, determinations of materiality require "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him. * * * TSC Industries, 426 U.S. at 450.

⁵ See, e.g., Concepts Statement 2, paragraphs 123–124; AU 312A.10 (materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations); AU 312A.34 ("Qualitative considerations also influence the auditor in reaching a conclusion as to whether misstatements are material."). As used in the accounting literature and in this SAB, "qualitative" materiality refers to the surrounding circumstances that inform an investor's evaluation of financial statement entries. Whether events may be material to investors for non-financial reasons is a matter not addressed by this SAB.

⁶ See, e.g., Rule 1-02(o) of Regulation S-X, 17 CFR 210.1-02(o), Rule 405 of Regulation C, 17 CFR 230.405, and Rule 12b-2, 17 CFR 240.12b-2; AU

The FASB has long emphasized that materiality cannot be reduced to a numerical formula. In its Concepts Statement 2, the FASB noted that some had urged it to promulgate quantitative materiality guides for use in a variety of situations. The FASB rejected such an approach as representing only a "minority view, stating—

The predominant view is that materiality judgments can properly be made only by those who have all the facts. The Board's present position is that no general standards of materiality could be formulated to take into account all the considerations that enter into an experienced human judgment.⁷

The FASB noted that, in certain limited circumstances, the Commission and other authoritative bodies had issued quantitative materiality guidance, citing as examples guidelines ranging from one to ten percent with respect to a variety of disclosures.⁸ And it took account of contradictory studies, one showing a lack of uniformity among auditors on materiality judgments, and another suggesting widespread use of a "rule of thumb" of five to ten percent of net income.⁹ The FASB also considered whether an evaluation of materiality could be based solely on anticipating the market's reaction to accounting information.¹⁰

The FASB rejected a formulaic approach to discharging "the onerous duty of making materiality decisions"¹¹ in favor of an approach that takes into account all the relevant considerations. In so doing, it made clear that—

[M]agnitude by itself, without regard to the nature of the item and the circumstances in which the judgment has to be made, will not generally be a sufficient basis for a materiality judgment.¹²

Evaluation of materiality requires a registrant and its auditor to consider all the relevant circumstances, and the staff believes that there are numerous circumstances in which misstatements below 5% could well be material. Qualitative factors may cause

312A.10—.11, 317.13, 411.04 n. 1, and 508.36; In re Kidder Peabody Securities Litigation, 10 F. Supp. 2d 398 (S.D.N.Y. 1998); *Parnes v. Gateway 2000, Inc.*, 122 F.3d 539 (8th Cir. 1997); In re Westinghouse Securities Litigation, 90 F.3d 696 (3d Cir. 1996); In the Matter of W.R. Grace & Co., Accounting and Auditing Enforcement Release ("AAER") 1140 (June 30, 1999); In the Matter of Eugene Gaughan, AAER 1141 (June 30, 1999); In the Matter of Thomas Scanlon, AAER 1142 (June 30, 1999); and In re Sensormatic Electronics Corporation, Sec. Act Rel. No. 7518 (March 25, 1998).

⁷ Concepts Statement 2, paragraph 131.

⁸ Concepts Statement 2, paragraphs 131 and 166.

⁹ Concepts Statement 2, paragraph 167.

¹⁰ Concepts Statement 2, paragraphs 168–169.

¹¹ Concepts Statement 2, paragraph 170.

¹² Concepts Statement 2, paragraph 125.

misstatements of quantitatively small amounts to be material; as stated in the auditing literature:

As a result of the interaction of quantitative and qualitative considerations in materiality judgments, misstatements of relatively small amounts that come to the auditor's attention could have a material effect on the financial statements.¹³

Among the considerations that may well render material a quantitatively small misstatement of a financial statement item are—

- Whether the misstatement arises from an item capable of precise measurement or whether it arises from an estimate and, if so, the degree of imprecision inherent in the estimate.¹⁴
- Whether the misstatement masks a change in earnings or other trends.
- Whether the misstatement hides a failure to meet analysts' consensus expectations for the enterprise.
- Whether the misstatement changes a loss into income or vice versa.
- Whether the misstatement concerns a segment or other portion of the registrant's business that has been identified as playing a significant role in the registrant's operations or profitability.
- Whether the misstatement affects the registrant's compliance with regulatory requirements.
- Whether the misstatement affects the registrant's compliance with loan covenants or other contractual requirements.
- Whether the misstatement has the effect of increasing management's compensation—for example, by satisfying requirements for the award of bonuses or other forms of incentive compensation.
- Whether the misstatement involves concealment of an unlawful transaction.

This is not an exhaustive list of the circumstances that may affect the materiality of a quantitatively small misstatement.¹⁵ Among other factors,

the demonstrated volatility of the price of a registrant's securities in response to certain types of disclosures may provide guidance as to whether investors regard quantitatively small misstatements as material. Consideration of potential market reaction to disclosure of a misstatement is by itself "too blunt an instrument to be depended on" in considering whether a fact is material.¹⁶ When, however, management or the independent auditor expects (based, for example, on a pattern of market performance) that a known misstatement may result in a significant positive or negative market reaction, that expected reaction should be taken into account when considering whether a misstatement is material.¹⁷

For the reasons noted above, the staff believes that a registrant and the auditors of its financial statements should not assume that even small intentional misstatements in financial statements, for example those pursuant to actions to "manage" earnings, are immaterial.¹⁸ While the intent of management does not render a misstatement material, it may provide significant evidence of materiality. The evidence may be particularly compelling where management has intentionally misstated items in the financial statements to "manage" reported earnings. In that instance, it presumably has done so believing that the resulting amounts and trends would be significant to users of the registrant's financial statements.¹⁹ The staff believes that investors generally would regard as significant a management practice to over- or under-state earnings up to an amount just short of a percentage threshold in order to "manage" earnings. Investors presumably also would regard as significant an accounting practice that, in essence, rendered all earnings figures subject to

recommendations to the Auditing Standards Board including suggestions regarding communications with audit committees about unadjusted misstatements. See generally Big Five Audit Materiality Task Force, "Materiality in a Financial Statement Audit—Considering Qualitative Factors When Evaluating Audit Findings" (August 1998).

¹⁶ See Concepts Statement 2, paragraph 169.

¹⁷ If management does not expect a significant market reaction, a misstatement still may be material and should be evaluated under the criteria discussed in this SAB.

¹⁸ Intentional management of earnings and intentional misstatements, as used in this SAB, do not include insignificant errors and omissions that may occur in systems and recurring processes in the normal course of business. See notes 37 and 49 *infra*.

¹⁹ Assessments of materiality should occur not only at year-end, but also during the preparation of each quarterly or interim financial statement. See, e.g., In the Matter of Venator Group, Inc., AAER 1049 (June 29, 1998).

a management-directed margin of misstatement.

The materiality of a misstatement may turn on where it appears in the financial statements. For example, a misstatement may involve a segment of the registrant's operations. In that instance, in assessing materiality of a misstatement to the financial statements taken as a whole, registrants and their auditors should consider not only the size of the misstatement but also the significance of the segment information to the financial statements taken as a whole.²⁰ "A misstatement of the revenue and operating profit of a relatively small segment that is represented by management to be important to the future profitability of the entity."²¹ is more likely to be material to investors than a misstatement in a segment that management has not identified as especially important. In assessing the materiality of misstatements in segment information—as with materiality generally—

Situations may arise in practice where the auditor will conclude that a matter relating to segment information is qualitatively material even though, in his or her judgment, it is quantitatively immaterial to the financial statements taken as a whole.²²

Aggregating and Netting Misstatements

In determining whether multiple misstatements cause the financial statements to be materially misstated, registrants and the auditors of their financial statements should consider each misstatement separately and the aggregate effect of all misstatements.²³ A registrant and its auditor should evaluate misstatements in light of quantitative and qualitative factors and "consider whether, in relation to individual amounts, subtotals, or totals in the financial statements, they materially misstate the financial statements taken as a whole."²⁴ This requires consideration of—

²⁰ See, e.g., In the Matter of W.R. Grace & Co., AAER 1140 (June 30, 1999).

²¹ AU 9326.33.

²² *Id.*

²³ The auditing literature notes that the "concept of materiality recognizes that some matters, either individually or in the aggregate, are important for fair presentation of financial statements in conformity with generally accepted accounting principles." AU 312.03. See also AU 312.04.

²⁴ AU 312.34. Quantitative materiality assessments often are made by comparing adjustments to revenues, gross profit, pretax and net income, total assets, stockholders' equity, or individual line items in the financial statements. The particular items in the financial statements to be considered as a basis for the materiality determination depend on the proposed adjustment to be made and other factors, such as those

¹³ AU 312.11.

¹⁴ As stated in Concepts Statement 2, paragraph 130:

Another factor in materiality judgments is the degree of precision that is attainable in estimating the judgment item. The amount of deviation that is considered immaterial may increase as the attainable degree of precision decreases. For example, accounts payable usually can be estimated more accurately than can contingent liabilities arising from litigation or threats of it, and a deviation considered to be material in the first case may be quite trivial in the second.

This SAB is not intended to change current law or guidance in the accounting literature regarding accounting estimates. See, e.g., Accounting Principles Board Opinion 20, Accounting Changes 10, 11, 31–33 (July 1971).

¹⁵ The staff understands that the Big Five Audit Materiality Task Force ("Task Force") was convened in March of 1998 and has made

the significance of an item to a particular entity (for example, inventories to a manufacturing company), the pervasiveness of the misstatement (such as whether it affects the presentation of numerous financial statement items), and the effect of the misstatement on the financial statements taken as a whole. * * * 25

Registrants and their auditors first should consider whether each misstatement is material, irrespective of its effect when combined with other misstatements. The literature notes that the analysis should consider whether the misstatement of "individual amounts" causes a material misstatement of the financial statements taken as a whole. As with materiality generally, this analysis requires consideration of both quantitative and qualitative factors.

If the misstatement of an individual amount causes the financial statements as a whole to be materially misstated, that effect cannot be eliminated by other misstatements whose effect may be to diminish the impact of the misstatement on other financial statement items. To take an obvious example, if a registrant's revenues are a material financial statement item and if they are materially overstated, the financial statements taken as a whole will be materially misleading even if the effect on earnings is completely offset by an equivalent overstatement of expenses.

Even though a misstatement of an individual amount may not cause the financial statements taken as a whole to be materially misstated, it may nonetheless, when aggregated with other misstatements, render the financial statements taken as a whole to be materially misleading. Registrants and the auditors of their financial statements accordingly should consider the effect of the misstatement on subtotals or totals. The auditor should aggregate all misstatements that affect each subtotal or total and consider whether the misstatements in the aggregate affect the subtotal or total in a way that causes the registrant's financial statements taken as a whole to be materially misleading.²⁶

The staff believes that, in considering the aggregate effect of multiple misstatements on a subtotal or total, registrants and the auditors of their financial statements should exercise particular care when considering

whether to offset (or the appropriateness of offsetting) a misstatement of an estimated amount with a misstatement of an item capable of precise measurement. As noted above, assessments of materiality should never be purely mechanical; given the imprecision inherent in estimates, there is by definition a corresponding imprecision in the aggregation of misstatements involving estimates with those that do not involve an estimate.

Registrants and auditors also should consider the effect of misstatements from prior periods on the current financial statements. For example, the auditing literature states,

Matters underlying adjustments proposed by the auditor but not recorded by the entity could potentially cause future financial statements to be materially misstated, even though the auditor has concluded that the adjustments are not material to the current financial statements.²⁷

This may be particularly the case where immaterial misstatements recur in several years and the cumulative effect becomes material in the current year.

2. Immaterial Misstatements That Are Intentional

Facts: A registrant's management intentionally has made adjustments to various financial statement items in a manner inconsistent with GAAP. In each accounting period in which such actions were taken, none of the individual adjustments is by itself material, nor is the aggregate effect on the financial statements taken as a whole material for the period. The registrant's earnings "management" has been effected at the direction or acquiescence of management in the belief that any deviations from GAAP have been immaterial and that accordingly the accounting is permissible.

Question: In the staff's view, may a registrant make intentional immaterial misstatements in its financial statements?

Interpretive Response: No. In certain circumstances, intentional immaterial misstatements are unlawful.

Considerations of the Books and Records Provisions under the Exchange Act

Even if misstatements are immaterial,¹ registrants must comply

with Sections 13(b)(2)–(7) of the Securities Exchange Act of 1934 (the "Exchange Act").² Under these provisions, each registrant with securities registered pursuant to Section 12 of the Exchange Act,³ or required to file reports pursuant to Section 15(d),⁴ must make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of assets of the registrant and must maintain internal accounting controls that are sufficient to provide reasonable assurances that, among other things, transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP.⁵ In this context, determinations of what constitutes "reasonable assurance" and "reasonable detail" are based not on a "materiality" analysis but on the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs.⁶ Accordingly, failure to record accurately immaterial items, in some instances, may result in violations of the securities laws.

The staff recognizes that there is limited authoritative guidance⁷ regarding the "reasonableness" standard in Section 13(b)(2) of the Exchange Act.

financial statements in a manner that plainly would be contrary to GAAP if the misstatement were material. The staff believes that the FASB did not intend this result.

² 15 U.S.C. 78m(b)(2)–(7).

³ 15 U.S.C. 78l.

⁴ 15 U.S.C. 78o(d).

⁵ Criminal liability may be imposed if a person knowingly circumvents or knowingly fails to implement a system of internal accounting controls or knowingly falsifies books, records or accounts. 15 U.S.C. 78m(4) and (5). See also Rule 13b2–1 under the Exchange Act, 17 CFR 240.13b2–1, which states, "No person shall, directly or indirectly, falsify or cause to be falsified, any book, record or account subject to Section 13(b)(2)(A) of the Securities Exchange Act."

⁶ 15 U.S.C. 78m(b)(7). The books and records provisions of section 13(b) of the Exchange Act originally were passed as part of the Foreign Corrupt Practices Act ("FCPA"). In the conference committee report regarding the 1988 amendments to the FCPA, the committee stated:

The conference committee adopted the prudent man qualification in order to clarify that the current standard does not connote an unrealistic degree of exactitude or precision. The concept of reasonableness of necessity contemplates the weighing of a number of relevant factors, including the costs of compliance.

Cong. Rec. H2116 (daily ed. April 20, 1988).

⁷ So far as the staff is aware, there is only one judicial decision that discusses Section 13(b)(2) of the Exchange Act in any detail, SEC v. World-Wide Coin Investments, Ltd., 567 F. Supp. 724 (N.D. Ga. 1983), and the courts generally have found that no private right of action exists under the accounting and books and records provisions of the Exchange Act. See e.g., Lamb v. Phillip Morris Inc., 915 F.2d 1024 (6th Cir. 1990) and JS Service Center Corporation v. General Electric Technical Services Company, 937 F. Supp. 216 (S.D.N.Y. 1996).

identified in this SAB. For example, an adjustment to inventory that is immaterial to pretax income or net income may be material to the financial statements because it may affect a working capital ratio or cause the registrant to be in default of loan covenants.

²⁵ AU 508.36.

²⁶ AU 312.34.

²⁷ AU 380.09.

¹ FASB Statements generally provide that "[t]he provisions of this Statement need not be applied to immaterial items." This SAB is consistent with that provision of the Statements. In theory, this language is subject to the interpretation that the registrant is free intentionally to set forth immaterial items in

A principal statement of the Commission's policy in this area is set forth in an address given in 1981 by then Chairman Harold M. Williams.⁸ In his address, Chairman Williams noted that, like materiality, "reasonableness" is not an "absolute standard of exactitude for corporate records."⁹ Unlike materiality, however, "reasonableness" is not solely a measure of the significance of a financial statement item to investors. "Reasonableness," in this context, reflects a judgment as to whether an issuer's failure to correct a known misstatement implicates the purposes underlying the accounting provisions of Sections 13(b)(2)–(7) of the Exchange Act.¹⁰

In assessing whether a misstatement results in a violation of a registrant's obligation to keep books and records that are accurate "in reasonable detail," registrants and their auditors should consider, in addition to the factors discussed above concerning an evaluation of a misstatement's potential materiality, the factors set forth below.

- The significance of the misstatement. Though the staff does not believe that registrants need to make finely calibrated determinations of significance with respect to immaterial items, plainly it is "reasonable" to treat misstatements whose effects are clearly inconsequential differently than more significant ones.

- How the misstatement arose. It is unlikely that it is ever "reasonable" for registrants to record misstatements or not to correct known misstatements—even immaterial ones—as part of an ongoing effort directed by or known to senior management for the purposes of "managing" earnings. On the other hand, insignificant misstatements that arise from the operation of systems or recurring processes in the normal course of business generally will not cause a registrant's books to be inaccurate "in reasonable detail."¹¹

⁸ The Commission adopted the address as a formal statement of policy in Securities Exchange Act Release No. 17500 (January 29, 1981), 46 FR 11544 (February 9, 1981), 21 SEC Docket 1466 (February 10, 1981).

⁹ *Id.* at 46 FR 11546.

¹⁰ *Id.*

¹¹ For example, the conference report regarding the 1988 amendments to the FCPA stated:

The Conferees intend to codify current Securities and Exchange Commission (SEC) enforcement policy that penalties not be imposed for insignificant or technical infractions or inadvertent conduct. The amendment adopted by the Conferees [Section 13(b)(4)] accomplishes this by providing that criminal penalties shall not be imposed for failing to comply with the FCPA's books and records or accounting provisions. This provision [Section 13(b)(5)] is meant to ensure that criminal penalties would be imposed where acts of

- The cost of correcting the misstatement. The books and records provisions of the Exchange Act do not require registrants to make major expenditures to correct small misstatements.¹² Conversely, where there is little cost or delay involved in correcting a misstatement, failing to do so is unlikely to be "reasonable."

- The clarity of authoritative accounting guidance with respect to the misstatement. Where reasonable minds may differ about the appropriate accounting treatment of a financial statement item, a failure to correct it may not render the registrant's financial statements inaccurate "in reasonable detail." Where, however, there is little ground for reasonable disagreement, the case for leaving a misstatement uncorrected is correspondingly weaker.

There may be other indicators of "reasonableness" that registrants and their auditors may ordinarily consider. Because the judgment is not mechanical, the staff will be inclined to continue to defer to judgments that "allow a business, acting in good faith, to comply with the Act's accounting provisions in an innovative and cost-effective way."¹³

The Auditor's Response to Intentional Misstatements

Section 10A(b) of the Exchange Act requires auditors to take certain actions upon discovery of an "illegal act."¹⁴ The statute specifies that these obligations are triggered "whether or not [the illegal acts are] perceived to have a material effect on the financial statements of the issuer. * * *" Among other things, Section 10A(b)(1) requires the auditor to inform the appropriate level of management of an illegal act (unless clearly inconsequential) and assure that the registrant's audit committee is "adequately informed" with respect to the illegal act.

commission or omission in keeping books or records or administering accounting controls have the purpose of falsifying books, records or accounts, or of circumventing the accounting controls set forth in the Act. This would include the deliberate falsification of books and records and other conduct calculated to evade the internal accounting controls requirement.

Cong. Rec. H2115 (daily ed. April 20, 1988).

¹² As Chairman Williams noted with respect to the internal control provisions of the FCPA, "[t]housands of dollars ordinarily should not be spent conserving hundreds." 46 FR 11546.

¹³ *Id.*, at 11547.

¹⁴ Section 10A(f) defines, for purposes of Section 10A, an "illegal act" as "an act or omission that violates any law, or any rule or regulation having the force of law." This is broader than the definition of an "illegal act" in AU 317.02, which states, "Illegal acts by clients do not include personal misconduct by the entity's personnel unrelated to their business activities."

As noted, an intentional misstatement of immaterial items in a registrant's financial statements may violate Section 13(b)(2) of the Exchange Act and thus be an illegal act. When such a violation occurs, an auditor must take steps to see that the registrant's audit committee is "adequately informed" about the illegal act. Because Section 10A(b)(1) is triggered regardless of whether an illegal act has a material effect on the registrant's financial statements, where the illegal act consists of a misstatement in the registrant's financial statements, the auditor will be required to report that illegal act to the audit committee irrespective of any "netting" of the misstatements with other financial statement items.

The requirements of Section 10A echo the auditing literature. See, for example, SAS Nos. 54 and 99. Pursuant to paragraph 77 of SAS 99, if the auditor determines there is evidence that fraud may exist, the auditor must discuss the matter with the appropriate level of management that is at least one level above those involved, and with senior management and the audit committee. The auditor must report directly to the audit committee fraud involving senior management and fraud that causes a material misstatement of the financial statements. Paragraph 6 of SAS 99 states that "misstatements arising from fraudulent financial reporting are intentional misstatements or omissions of amounts or disclosures in financial statements designed to deceive financial statement users * * *." SAS 99 further states that fraudulent financial reporting may involve falsification or alteration of accounting records; misrepresenting or omitting events, transactions or other information in the financial statements; and the intentional misapplication of accounting principles relating to amounts, classifications, the manner of presentation, or disclosures in the financial statements.¹⁵ The clear

¹⁵ An unintentional illegal act triggers the same procedures and considerations by the auditor as a fraudulent misstatement if the illegal act has a direct and material effect on the financial statements. See AU 110 n. 1, 317.05 and 317.07. Although distinguishing between intentional and unintentional misstatements is often difficult, the auditor must plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatements in either case.

¹⁶ Although the auditor is not required to plan or perform the audit to detect misstatements that are immaterial to the financial statements, SAS 99 requires the auditor to evaluate several fraud "risk factors" that may bring such misstatements to his or her attention. For example, an analysis of fraud risk factors under SAS 99 must include, among other things, consideration of management's interest in maintaining or increasing the registrant's stock price or earnings trend through the use of unusually aggressive accounting practices, whether

Continued

implication of SAS 99 is that immaterial misstatements may be fraudulent financial reporting.¹⁷

Auditors that learn of intentional misstatements may also be required to (1) re-evaluate the degree of audit risk involved in the audit engagement, (2) determine whether to revise the nature, timing, and extent of audit procedures accordingly, and (3) consider whether to resign.¹⁸

Intentional misstatements also may signal the existence of reportable conditions or material weaknesses in the registrant's system of internal accounting control designed to detect and deter improper accounting and financial reporting.¹⁹ As stated by the National Commission on Fraudulent Financial Reporting, also known as the Treadway Commission, in its 1987 report,

The tone set by top management—the corporate environment or culture within which financial reporting occurs—is the most important factor contributing to the integrity of the financial reporting process. Notwithstanding an impressive set of written rules and procedures, if the tone set by management is lax, fraudulent financial reporting is more likely to occur.²⁰

An auditor is required to report to a registrant's audit committee any reportable conditions or material weaknesses in a registrant's system of internal accounting control that the auditor discovers in the course of the examination of the registrant's financial statements.²¹

management has a practice of committing to analysts or others that it will achieve unduly aggressive or clearly unrealistic forecasts, and the existence of assets, liabilities, revenues, or expenses based on significant estimates that involve unusually subjective judgments or uncertainties.

¹⁷ In requiring the auditor to consider whether fraudulent misstatements are material, and in requiring differing responses depending on whether the misstatement is material, SAS 99 makes clear that fraud can involve immaterial misstatements. Indeed, a misstatement can be "inconsequential" and still involve fraud.

Under SAS 99, assessing whether misstatements due to fraud are material to the financial statements is a "cumulative process" that should occur both during and at the completion of the audit. SAS 99 further states that this accumulation is primarily a "qualitative matter" based on the auditor's judgment. The staff believes that in making these assessments, management and auditors should refer to the discussion in Part 1 of this SAB.

¹⁸ Auditors should document their determinations in accordance with SAS 96, SAS 99, and other appropriate sections of the audit literature.

¹⁹ See, e.g., SAS 99.

²⁰ Report of the National Commission on Fraudulent Financial Reporting at 32 (October 1987). See also Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (February 8, 1999).

²¹ AU 325.02. See also AU 380.09, which, in discussing matters to be communicated by the auditor to the audit committee, states:

GAAP Precedence Over Industry Practice

Some have argued to the staff that registrants should be permitted to follow an industry accounting practice even though that practice is inconsistent with authoritative accounting literature. This situation might occur if a practice is developed when there are few transactions and the accounting results are clearly inconsequential, and that practice never changes despite a subsequent growth in the number or materiality of such transactions. The staff disagrees with this argument. Authoritative literature takes precedence over industry practice that is contrary to GAAP.²²

General Comments

This SAB is not intended to change current law or guidance in the accounting or auditing literature.²³ This SAB and the authoritative accounting literature cannot specifically address all of the novel and complex business transactions and events that may occur. Accordingly, registrants may account for, and make disclosures about, these transactions and events based on analogies to similar situations or other factors. The staff may not, however, always be persuaded that a registrant's determination is the most appropriate under the circumstances. When disagreements occur after a transaction or an event has been reported, the

The auditor should inform the audit committee about adjustments arising from the audit that could, in his judgment, either individually or in the aggregate, have a significant effect on the entity's financial reporting process. For purposes of this section, an audit adjustment, whether or not recorded by the entity, is a proposed correction of the financial statements. * * *

²² See AU 411.05

²³ The FASB Discussion Memorandum, "Criteria for Determining Materiality;" states that the financial accounting and reporting process considers that "a great deal of the time might be spent during the accounting process considering insignificant matters. * * * If presentations of financial information are to be prepared economically on a timely basis and presented in a concise intelligible form, the concept of materiality is crucial." This SAB is not intended to require that misstatements arising from insignificant errors and omissions (individually and in the aggregate) arising from the normal recurring accounting close processes, such as a clerical error or an adjustment for a missed accounts payable invoice, always be corrected, even if the error is identified in the audit process and known to management. Management and the auditor would need to consider the various factors described elsewhere in this SAB in assessing whether such misstatements are material, need to be corrected to comply with the FCPA, or trigger procedures under Section 10A of the Exchange Act. Because this SAB does not change current law or guidance in the accounting or auditing literature, adherence to the principles described in this SAB should not raise the costs associated with recordkeeping or with audits of financial statements.

consequences may be severe for registrants, auditors, and, most importantly, the users of financial statements who have a right to expect consistent accounting and reporting for, and disclosure of, similar transactions and events. The staff, therefore, encourages registrants and auditors to discuss on a timely basis with the staff proposed accounting treatments for, or disclosures about, transactions or events that are not specifically covered by the existing accounting literature.

Topic 2: Business Combinations

A. Purchase Method

1. Deleted by SAB 103
2. Deleted by SAB 103
3. Deleted by SAB 103
4. Deleted by SAB 103
5. Adjustments to Allowances for Loan Losses in Connection With Business Combinations

Facts: Bank A acquires Bank B in a business combination.

Question: Are there circumstances in which it is appropriate for Bank A, in assigning acquisition cost to the loan receivables acquired from Bank B, to adjust Bank B's carrying value for those loans not only to reflect appropriate current interest rates, but also to reflect a different estimate of uncollectibility?¹

Interpretive Response: Needed changes in allowances for loan losses are ordinarily to be made through provisions for loan losses rather than through purchase accounting adjustments. Except in the limited circumstances discussed below, where Bank A has plans for ultimate recovery of loans acquired from Bank B that are demonstrably different from plans that had served as the basis for Bank B's estimate of loan losses, purchase accounting adjustments reflecting different estimates of uncollectibility may raise questions from the staff as to: (a) The reasonableness of the preacquisition allowance for loan losses recorded by Bank B, or (b) whether the adjustments will have a distortive effect on current or future period financial statements of Bank A. Similar questions may be raised by the staff regarding significant changes in allowances for loan losses that are recorded by a bank shortly before it is acquired.

Estimation of probable loan losses involves judgment, and Banks A and B

¹ Under Statement 141, the guidelines for allocating acquisition cost to receivable is "at present values of amounts to be received determined at appropriate current interest rates, less allowances for uncollectibility and collection cost, if necessary."

may differ in their systematic approaches to such estimation. Nevertheless, assuming that appropriate methodology (*i.e.*, giving due consideration to all relevant facts and circumstances affecting collectibility) is followed by each bank, the staff believes that each bank's estimate of the uncollectible portion of Bank B's loan portfolio should fall within a range of acceptability. That is, the staff believes that the uncollectible portion of Bank B's loans as estimated separately by the two banks ordinarily should not be different by an amount that is material to the financial statements of Bank B and, therefore, an adjustment to the net carrying value of Bank B's loan portfolio at the acquisition date to reflect a different estimate of uncollectibility ordinarily would be unnecessary and inappropriate.

However, a purchase accounting adjustment to reflect a different estimate of uncollectibility may be appropriate where Bank A has plans regarding ultimate recovery of certain acquired loans demonstrably different from the plans that had served as the basis for Bank B's estimation of losses on those loans.² In such circumstances, Bank B's estimate of uncollectibility for those certain loans may be largely or entirely irrelevant for purposes of determining the net carrying value at which those loans should be recorded by Bank A. For example, if Bank B had intended to hold certain loans to maturity but Bank A plans to sell them, the acquisition cost allocated to those loans should equal the value that currently could be obtained for them in a sale.³ In that case, Bank A would report those loans as assets held for sale rather than as part of its loan portfolio, and would report them in postacquisition periods at the lower of cost or market value until sold.

The staff does not intend to suggest that an acquiring bank should record acquired loans at an amount that reflects an unreasonable estimate of uncollectibility. If Bank B's financial statements as of the acquisition date are not fairly stated in accordance with

generally accepted accounting principles because of an unreasonable allowance for loan losses, that allowance for loan losses should not serve as a basis for recording the acquired loans. Rather, Bank B's preacquisition financial statements should be restated to reflect an appropriate allowance, with the resultant adjustment being applied to the restated preacquisition income statement of Bank B for the period(s) in which the events or changes in conditions that gave rise to the needed change in the allowance occurred.

6. Debt Issue Costs

Facts: Company A is to acquire the net assets of Company B in a transaction to be accounted for as a business combination. In connection with the transaction, Company A has retained an investment banker to provide advisory services in structuring the acquisition and to provide the necessary financing. It is expected that the acquisition will be financed on an interim basis using "bridge financing" provided by the investment banker. Permanent financing will be arranged at a later date through a debt offering, which will be underwritten by the investment banker. Fees will be paid to the investment banker for the advisory services, the bridge financing and the underwriting of the permanent financing. These services may be billed separately or as a single amount.

Question 1: Are all fees paid to the investment banker a direct cost of the acquisition and, as such, accounted for as an element of the purchase price of the business acquired?

Interpretive Response: No. Fees paid to an investment banker in connection with a business combination, when the investment banker is also providing interim financing or underwriting services, must be allocated between direct costs of the acquisition and debt issue costs.

Statement 141 provides that direct costs such as finder's fees and fees paid to outside consultants should be treated as components of the cost of the acquisition, while the costs of registering and issuing any equity securities are treated as a reduction of the otherwise determined fair value of the equity securities. However, debt issue costs are an element of the effective interest cost of the debt, and neither the source of the debt financing nor the use of the debt proceeds changes the nature of such costs. Accordingly, they should not be considered a direct cost of the acquisition.

The portions of the fees allocated to direct costs and to debt issue costs

should be representative of the actual services provided. Thus, in making a reasonable allocation (or in determining that an allocation made by the investment banker is reasonable¹ factors such as (i) the fees charged by investment bankers in connection with other recent bridge financings and (ii) fees charged for advisory services when obtained separately, should normally be considered to determine the relative fair values of the two services. Whether these or other factors are considered, the allocation should normally result in an effective debt service cost (interest and amortization of debt issue costs² which is comparable to the effective cost of other recent debt issues of similar investment risk and maturity. The amount accounted for as debt issue costs should be separately disclosed, if material.¹

Question 2: May the debt issue costs of the interim "bridge financing" be amortized over the anticipated combined life of the bridge and permanent financings?

Interpretive Response: No. Debt issue costs should be amortized by the interest method over the life of the debt to which they relate. Debt issue costs related to the bridge financing should be recognized as interest cost during the estimated interim period preceding the placement of the permanent financing with any unamortized amounts charged to expense if the bridge loan is repaid prior to the expiration of the estimated period. Where the bridged financing consists of increasing rate debt, the consensus reached in EITF Issue 86-15 should be followed.⁴

7. Loss Contingencies Assumed in a Business Combination

Facts: A registrant acquires a business enterprise in a business combination. In connection with the acquisition, the acquiring company assumes certain contingent liabilities of the acquired company.

Question: How should the acquiring company account for and disclose contingent liabilities that have been assumed in a business combination?

¹ This would apply irrespective of whether the fees for the services were billed as a single amount or separately, since the separate billing of the services implicitly involves an allocation by the investment banker.

² See Question 2 regarding the period over which the debt issue costs related to bridge financings should be amortized.

³ See Rule 5-02(17) of Regulations S-X.

⁴ As noted in the "Status" section of the Abstract to Issue 86-15, the term-extending provisions of the debt instrument should be analyzed to determine whether they constitute an embedded derivative requiring separate accounting in accordance with Statement 133 (as amended).

² A bank's plans for recovering the net carrying value of certain individual loans or groups of loans may differ from its plans regarding other loans. The plan for recovering the net carrying value of a loan might be, for example, (a) holding the loan to maturity, (b) selling it, or (c) foreclosing on the collateral underlying the loan. The assigned value of loans should be based on the plan for recovery.

³ It is not acceptable to recognize losses on loans that are due to concerns as to ultimate collectibility through a purchase accounting adjustment, nor is it acceptable to report such losses as "loss on sale." An excess of carrying value of Bank B's loans over their market value at the acquisition date that is due to concerns as to ultimate collectibility should have been recognized by Bank B through its provision for loan losses.

Interpretive Response: In accordance with Statement 141, the acquiring company should allocate the cost of an acquired company to the assets acquired and liabilities assumed based on their fair values at the date of acquisition. With respect to contingencies for which a fair value is not determinable at the date of acquisition, the guidance of Statement 5 and Interpretation 14 should be applied. If the registrant is awaiting additional information that it has arranged to obtain for the measurement of a contingency during the allocation period specified by Statement 141, the staff believes that the registrant should disclose that the purchase price allocation is preliminary. In that circumstance, the registrant should describe the nature of the contingency and furnish other available information that will enable a reader to understand its potential effects on the final allocation and on post-acquisition operating results. Management's Discussion and Analysis should include appropriate disclosure regarding any unrecognized preacquisition contingency and its reasonably likely effects on operating results, liquidity, and financial condition.

The staff believes that the allocation period should not extend beyond the minimum reasonable period necessary to gather the information that the registrant has arranged to obtain for purposes of the estimate. Since an allocation period usually should not exceed one year, registrants believing that they will require a longer period are encouraged to discuss their circumstances with the staff. If it is unlikely that the liability can be estimated on the basis of information known to be obtainable at the time of the initial purchase price allocation, the allocation period should not be extended with respect to that liability. An adjustment to the contingent liability after the expiration of the allocation period would be recognized as an element of net income.

8. Business Combinations Prior to an Initial Public Offering

Facts: Two or more businesses combine in a single combination just prior to or contemporaneously with an initial public offering.

Question: Does the guidance in SAB Topic 5.G apply to business combinations entered into just prior to or contemporaneously with an initial public offering?

Interpretive Response: No. The guidance in SAB Topic 5.G is intended to address the transfer, just prior to or contemporaneously with an initial public offering, of nonmonetary assets

in exchange for a company's stock. The guidance in SAB Topic 5.G is not intended to modify the requirements of Statement 141.¹ Accordingly, the staff believes that the combination of two or more businesses should be accounted for in accordance with Statement 141.

9. Liabilities Assumed in a Business Combination

Facts: Company A acquires Company Z in a business combination. Company Z has recorded liabilities for contingencies such as product warranties and environmental costs.

Question: Are there circumstances in which it is appropriate for Company A to adjust Company Z's carrying value for these liabilities in the purchase price allocation?

Interpretive Response: Yes. Statement 141 requires that receivables, liabilities, and accruals be recorded in the purchase price allocation at their fair value, typically the present value of amounts to be received or paid, determined using appropriate current market interest rates. In some cases, fair value is readily determinable from contemporaneous arms-length transactions involving substantially identical assets or liabilities, or from amounts quoted by a third party to purchase the assets or assume the liabilities. More frequently, fair values are based on estimations of the underlying cash flows to be received or paid, discounted to their present value using appropriate current market interest rates.

The historical accounting by Company Z for receivables or liabilities may often be premised on estimates of the amounts to be received or paid. Amounts recorded by Company A in its purchase price allocation may be expected to differ from Company Z's historical carrying values due, at least, to the effects of the acquirer's discounting, including differences in interest rates. Estimation of probable losses and future cash flows involves judgment, and companies A and Z may differ in their systematic approaches to such estimation. Nevertheless, assuming that both companies employ a methodology that appropriately considers all relevant facts and circumstances affecting cash flows, the staff believes that the two estimates of undiscounted cash inflows and outflows should not differ by an amount that is material to the financial statements of

Company Z, unless Company A will settle the liability in a manner demonstrably different from the manner in which Company Z had planned to do so (for example, settlement of the warranty obligation through outsourcing versus an internal service department). But the source of other differences in the estimates of the undiscounted cash flows to be received or paid should be investigated and reconciled. If those estimates of undiscounted cash flows are materially different, an accounting error in Company Z's historical financial statements may be present, or Company A may be unaware of important information underlying Company Z's estimates that also is relevant to an estimate of fair value.

The staff is not suggesting that an acquiring company should record assumed liabilities at amounts that reflect an unreasonable estimate. If Company Z's financial statements as of the acquisition date are not fairly stated in accordance with GAAP because of an improperly recorded liability, that liability should not serve as a basis for recording assumed amounts. That is, the correction of a seller's erroneous application of GAAP should not occur through the purchase price allocation. Rather, Company Z's financial statements should be restated to reflect an appropriate amount, with the resultant adjustment being applied to the historical income statement of Company Z for the period(s) in which the trends, events, or changes in operations and conditions that gave rise to the needed change in the liability occurred. It would also be inappropriate for Company Z to report the amount of any necessary adjustment in the period just prior to the acquisition, unless that is the period in which the trends, events, or changes in operations and conditions occurred. The staff would expect that such trends, events, and changes would be disclosed in Management's Discussion and Analysis in the appropriate period(s) if their effect was material to a company's financial position, results of operations or cash flows.

In summary, the staff believes that purchase price adjustments necessary to record liabilities and loss accruals at fair value typically are required, while merely adding an additional "cushion" of 10 or 20 or 30 percent to such account balances is not appropriate. To arrive at those fair values, the undiscounted cash flows must be projected, period by period, based on historical experience and discounted at the appropriate current market discount rate.

¹ The provisions of Statement 141 apply to transactions involving the transfer of net assets as well as the acquisition of stock of a corporation. This guidance does not address the accounting for joint ventures or leverage buy-out transactions as discussed in EITF Issue 88-16.

B. Deleted by SAB 103

C. Deleted by SAB 103

D. Financial Statements of Oil and Gas Exchange Offers

Facts: The oil and gas industry has experienced periods of time where there have been a significant number of “exchange offers” (also referred to as “roll-ups” or “put-togethers”) to form a publicly held company, take an existing private company public, or increase the size of an existing publicly held company. An exchange offer transaction involves a swap of shares in a corporation for interests in properties, typically limited partnership interests. Such interests could include direct interests such as working interests and royalties related to developed or undeveloped properties and indirect interests such as limited partnership interests or shares of existing oil and gas companies. Generally, such transactions are structured to be tax-free to the individual or entity trading the property interest for shares of the corporation. Under certain circumstances, however, part or all of the transaction may be taxable. For purposes of the discussion

in this Topic, in each of these situations, the entity(ies) or property(ies) are deemed to constitute a business.

The fundamental accounting issues in exchange transactions involve determining the basis at which the properties exchanged should be recorded and deciding what prior financial results of the entities should be reported. In this regard, Statement 141 specifies that a business combination be accounted for using the purchase method. Statement 141 speaks specifically to business combinations between nonaffiliated enterprises. When affiliated enterprises (under common control) are involved, the guidance in paragraphs D11–D13 of Statement 141 should be followed. In particular, paragraph D12 states:

When accounting for a transfer of assets or exchange of shares between entities under common control, the entity that receives the net assets or the equity interest shall initially recognize the assets and liabilities transferred at their carrying amounts in the accounts of the transferring entity at the date of transfer.

Paragraph D13 states:

The purchase method of accounting shall be applied if the effect of the transfer or

exchange * * * is the acquisition of all or a part of the noncontrolling equity interests in a subsidiary.

The staff has developed administrative policies which it has followed with respect only to the financial statements of oil and gas exchange offers included in filings with the Commission and the conclusions expressed in this Topic should not be analogized to other circumstances.

Question 1: What are the staff's general guidelines in determining the appropriate basis of accounting in an exchange transaction?

Interpretive Response: The staff believes the basis of accounting should be determined pursuant to the provisions of Statement 141, if it is applicable. Accordingly, where unrelated parties are involved, it is appropriate to apply purchase accounting based on the fair value of either the stock issued or the properties involved.

The following chart shows the method of accounting to be used under some relatively simple sets of circumstances.

ACCOUNTING—BASED ON STATUS OF ISSUING ENTITY

Condition	Public company ¹	Non-public company ²
High degree of common ownership or common control between issuing corporation and offerees ³ .	Purchase accounting based on fair value of stock ⁴ .	Entities under common control—carry-over basis
All other, i.e., without common ownership or control.	Purchase accounting based on fair value of stock.	Purchase accounting based on fair value of properties.

¹ Issuing corporation is an existing public company before the exchange offer with an established market for its stock (includes situations involving use of a shell company established by a public company).

² Issuing corporation is not public prior to the exchange offer and thus has no established market for its stock.

³ Common control ordinarily exists where the issuing corporation acts as general partner for the offeree partnership(s). Where all the following conditions apply, common control will be considered to exist between the issuing corporation and the offerees even though the issuer does not exercise the same legal powers as a general partner:

- a. The issuer or its survivor initially acquired the property for exploration and development and
- b. Other investors were of a passive nature, solicited to provide financing with the hope of a return on their investment, and
- c. The issuer or its survivor has continued to exercise day-to-day managerial control.

⁴ In rare instances, such as when the property interest owners accepting the exchange offer acquire a majority of the voting shares of the company emerging from the exchange transaction, reorganization accounting may be considered appropriate. In such cases, the particular facts and circumstances should be reviewed with the Commission staff.

This chart reflects the staff's view that purchase accounting is generally appropriate except in situations where the principles for transactions involving common control apply. When a non-public entity acts as offeror to a group of related entities, the transaction is essentially a reorganization, and thus there is no basis for a change in the cost basis of the properties involved. If an existing public company (with an established market for its stock) has common ownership or control with the offerees, and the offerees acquire a majority interest in the emerging company, a question may arise as to

whether the transaction is a reorganization.

Question 2: In some situations, a non-public issuer may be affiliated with some but not all of the offerees. Assuming the nonaffiliated offerees are not deemed “co-promoters” of the new entity, how should such a transaction be accounted for?

Interpretive Response: The property interests acquired from affiliated and nonaffiliated parties should each be accounted for as though acquired in separate exchange offer transactions. Thus in some circumstances, it may be necessary to record the interests owned by affiliated persons at predecessor cost

while recording the interests of nonaffiliated persons as a purchase.

Example: Facts—D Company (a non-public company) forms a shell, E Company, to become its successor and to sponsor an exchange offer. E makes the exchange offer to four entities: A, B, C and D. A and B are unaffiliated; C is a limited partnership sponsored by D. The shareholders of D will become the principal or controlling shareholders of E.

Basis of Accounting—Since there is no market for E's stock, it should record the properties received from C and from D at their predecessor cost. The properties received from A and B

should be recorded at their fair market value.

Question 3: How should “common control accounting” be applied to the specific assets and liabilities of the new exchange company?

Interpretive Response: Under “common control accounting” the various accounting methods followed by the offeree entities should be conformed to the methods adopted by the new exchange company. It is not appropriate to combine assets and liabilities accounted for on different bases. Accordingly, as in the case of any merger between oil and gas companies, all of the oil and gas properties of the new entity must be accounted for on the same basis (either full cost or successful efforts) applied retroactively.

Question 4: In Form 10-K filings with the Commission, the staff has permitted limited partnerships to omit certain of the oil and gas reserve data disclosures required by Statement 69 in some circumstances. Is it permissible to omit these disclosures from the financial statements included in an exchange offering?

Interpretive Response: No. Normally full disclosures of reserve data and related information are required. The exemptions previously allowed relate only to partnerships where value-oriented data are otherwise available to the limited partners pursuant to the partnership agreement. The staff has previously stated that it will require all of the required disclosures for partnerships which are the subject of merger or exchange offers.⁵ These disclosures may, however, be presented on a combined basis.

The staff believes that the financial statements in an exchange offer registration statement should provide sufficient historical reserve quantity and value-based disclosures to enable offerees and secondary market public investors to evaluate the effect of the exchange proposal. Accordingly, in all cases, it will be necessary to present information as of the latest year-end on reserve quantities and the future net revenues associated with such quantities. In certain circumstances, where the exchange is accounted for as a purchase, the staff will consider, on a case-by-case basis, granting exemptions from (i) the disclosure requirements for year-to-year reconciliations of reserve quantities, and (ii) the requirements for a summary of oil and gas producing activities and a summary of changes in the net present value of reserves. For instance, the staff may consider requests for exemptions in cases where the

properties acquired in the exchange transaction are fully explored and developed, particularly if the management of the emerging company has not been involved in the exploration and development of such properties.

Question 5: Assume an exchange transaction is to be accounted for as a purchase and recorded at the fair value of the properties. If the exchange company will use the full cost method of accounting, does the full cost ceiling limitation apply as of the date of the financial statements reflecting the exchange?

Interpretive Response: Yes. The full cost ceiling limitation on costs capitalized does apply. However, as discussed under Topic 12.D.3, the Commission has stated that in unusual circumstances, registrants may request an exemption if as a result of a major purchase, a write-down would be required even though it can be demonstrated that the fair value of the properties clearly exceeds the unamortized costs.

Question 6: What pro forma financial information is required in an exchange offer filing?

Interpretive Response: The requirements for pro forma financial information in exchange offer filings are the same as in any other filings with the Commission and are detailed in Article 11 of Regulation S-X.⁶ Rule 11-02(b) specifies the presentation requirements, including periods presented and types of adjustments to be made. The general criteria of Rule 11-02(b)(6) are that pro forma adjustments should give effect to events that are (i) directly attributable to the transaction, (ii) expected to have a continuing impact on the registrant and (iii) factually supportable. In the case of an exchange offer, such adjustments typically are made to:

(1) Show varying levels of acceptance of the offer.

(2) Conform the accounting methods used in the historical financial statements to those to be applied by the new entity.

(3) Recompute the depreciation, depletion and amortization charges, in cases where the new entity will use full-cost accounting, on a combined basis. If this computation is not practicable, and the exchange offer is accounted for as a reorganization, historical depreciation, depletion and amortization provisions may be aggregated, with appropriate disclosure.

(4) Reflect purchase cost in the pro forma statements (where the exchange offer is accounted for on the purchase basis), including depreciation, depletion

and amortization based on the purchase cost.

(5) Provide pro forma reserve information.

(6) Reflect significant changes, if any, in levels of operations (revenues or costs), or in income tax status and to reflect debt incurred in connection with the transaction.

In addition, the depreciation, depletion and amortization rate which will apply for the initial period subsequent to consummation of the exchange offer should be disclosed.

Question 7: Are there conditions under which the presentation of other than full historical financial statements would be acceptable?

Interpretive Response: Generally, full historical financial statements as specified in Rules 3-01 and 3-02 of Regulations S-X are considered necessary to enable offerees and secondary market investors to evaluate the transaction. Where securities are being registered to offer to the security holders (including limited partners and other ownership interests) of the businesses to be acquired, such financial statements are normally required pursuant to Rule 3-05 of Regulation S-X, either individually for each entity or, where appropriate, separately for the offeror and on a combined basis for other entities, generally excluding corporations. However, certain exceptions may apply as explained in the outline below:

A. Purchase Accounting

1. If the registrant can demonstrate that full historical financial statements of the offeree partnerships are not reasonably available, the staff may permit presentation of audited Statements of Combined Gross Revenues and Direct Lease Operating Expenses for all years for which an income statement would otherwise be required. In these circumstances, the registrant should also disclose in an unaudited footnote the amounts of total exploration and development costs, and general and administrative expenses along with the reasons why presentation of full historical financial statements is not practicable.

2. The staff will consider requests to waive the requirement for prior year financial statements of the offeree partnerships and instead allow presentation of only the latest fiscal year and interim period, if the registrant can demonstrate that the prior years' data would not be meaningful because the offeree partnerships had no material quantity of production.

⁵ See SAB 40, Topic 12.A.3.c.

⁶ As announced in FRR 2 (July 9, 1982).

B. Common Control Accounting

The staff would expect the full historical financial statements as specified in Rules 3–01 and 3–02 of Regulation S–X would be included in the registration statement for exchange offers accounted for as reorganizations, including all required supplemental reserve information. The presentation of individual or combined financial statements would depend on the circumstances of the particular exchange offer.

Registrants are also reminded that wherever historical results are presented, it may be appropriate to explain the reasons why historical costs are not necessarily indicative of future expenditures.

E. Deleted by SAB 103

F. Deleted by SAB 103

Topic 3: Senior Securities**A. Convertible Securities**

Facts: Company B proposes to file a registration statement covering convertible securities.

Question: In registration, what consideration should be given to the dilutive effects of convertible securities?

Interpretive Response: In a registration statement of convertible preferred stock or debentures, the staff believes that disclosure of pro forma earnings per share (EPS) is important to investors when the proceeds will be used to extinguish existing preferred stock or debt and such extinguishments will have a material effect on EPS. That disclosure is required by Article 11, Rule 11–01(a)(8) and Rule 11–02(a)(7) of Regulation S–X, if material.

B. Deleted by ASR 307

C. Redeemable Preferred Stock

Facts: Rule 5–02.28 of Regulation S–X states that redeemable preferred stocks are not to be included in amounts reported as stockholders' equity, and that their redemption amounts are to be shown on the face of the balance sheet. However, the Commission's rules and regulations do not address the carrying amount at which redeemable preferred stock should be reported, or how changes in its carrying amount should be treated in calculations of earnings per share and the ratio of earnings to combined fixed charges and preferred stock dividends.

Question 1: How should the carrying amount of redeemable preferred stock be determined?

Interpretive Response: The initial carrying amount of redeemable preferred stock should be its fair value at date of issue. Where fair value at date

of issue is less than the mandatory redemption amount, the carrying amount shall be increased by periodic accretions, using the interest method, so that the carrying amount will equal the mandatory redemption amount at the mandatory redemption date. The carrying amount shall be further periodically increased by amounts representing dividends not currently declared or paid, but which will be payable under the mandatory redemption features, or for which ultimate payment is not solely within the control of the registrant (e.g., dividends that will be payable out of future earnings). Each type of increase in carrying amount shall be effected by charges against retained earnings or, in the absence of retained earnings, by charges against paid-in capital.

The accounting described in the preceding paragraph would apply irrespective of whether the redeemable preferred stock may be voluntarily redeemed by the issuer prior to the mandatory redemption date, or whether it may be converted into another class of securities by the holder. Companies also should consider the guidance in EITF Topic D–98.

Question 2: How should periodic increases in the carrying amount of redeemable preferred stock be treated in calculations of earnings per share and ratios of earnings to combined fixed charges and preferred stock dividends?

Interpretive Response: Each type of increase in carrying amount described in the Interpretive Response to Question 1 should be treated in the same manner as dividends on nonredeemable preferred stock.

Topic 4: Equity Accounts**A. Subordinated Debt**

Facts: Company E proposes to include in its registration statement a balance sheet showing its subordinate debt as a portion of stockholders' equity.

Question: Is this presentation appropriate?

Interpretive Response: Subordinated debt may not be included in the stockholders' equity section of the balance sheet. Any presentation describing such debt as a component of stockholders' equity must be eliminated. Furthermore, any caption representing the combination of stockholders' equity and only subordinated debts must be deleted.

B. S Corporations

Facts: An S corporation has undistributed earnings on the date its S election is terminated.

Question: How should such earnings be reflected in the financial statements?

Interpretive Response: Such earnings must be included in the financial statements as additional paid-in capital. This assumes a constructive distribution to the owners followed by a contribution to the capital of the corporation.

C. Change In Capital Structure

Facts: A capital structure change to a stock dividend, stock split or reverse split occurs after the date of the latest reported balance sheet but before the release of the financial statements or the effective date of the registration statement, whichever is later.

Question: What effect must be given to such a change?

Interpretive Response: Such changes in the capital structure must be given retroactive effect in the balance sheet. An appropriately cross-referenced note should disclose the retroactive treatment, explain the change made and state the date the change became effective.

D. Earnings Per Share Computations In An Initial Public Offering

Facts: A registration statement is filed in connection with an initial public offering (IPO) of common stock. During the periods covered by income statements that are included in the registration statement or in the subsequent period prior to the effective date of the IPO, the registrant issued for nominal consideration¹ common stock, options or warrants to purchase common stock or other potentially dilutive instruments (collectively, referred to hereafter as "nominal issuances").

Prior to the effective date of Statement 128, the staff believed that certain stock and warrants² should be treated as outstanding for all reporting periods in the same manner as shares issued in a stock split or a recapitalization effected contemporaneously with the IPO. The dilutive effect of such stock and warrants could be measured using the treasury stock method.

Question 1: Does the staff continue to believe that such treatment for stock and warrants would be appropriate upon adoption of Statement 128?

¹ Whether a security was issued for nominal consideration should be determined based on facts and circumstances. The consideration the entity receives for the issuance should be compared to the security's fair value to determine whether the consideration is nominal.

² The stock and warrants encompassed by the prior guidance were those issuances of common stock at prices below the IPO price and options or warrants with exercise prices below the IPO price that were issued within a one-year period prior to the initial filing of the registration statement relating to the IPO through the registration statement's effective date.

Interpretive Response: Generally, no. Historical EPS should be prepared and presented in conformity with Statement 128.

In applying the requirements of Statement 128, the staff believes that nominal issuances are recapitalizations in substance. In computing basic EPS for the periods covered by income statements included in the registration statement and in subsequent filings with the SEC, nominal issuances of common stock should be reflected in a manner similar to a stock split or stock dividend for which retroactive treatment is required by paragraph 54 of Statement 128. In computing diluted EPS for such periods, nominal issuances of common stock and potential common stock³ should be reflected in a manner similar to a stock split or stock dividend.

Registrants are reminded that disclosure about materially dilutive issuances is required outside the financial statements. Item 506 of Regulation S-K requires tabular presentation of the dilutive effects of those issuances on net tangible book value. The effects of dilutive issuances on the registrant's liquidity, capital resources and results of operations should be addressed in Management's Discussion and Analysis.

Question 2: Does reflecting nominal issuances as outstanding for all historical periods in the computation of earnings per share alter the registrant's responsibility to determine whether compensation expense must be recognized for such issuances to employees?

Interpretive Response: No. Registrants must follow GAAP in determining whether the recognition of compensation expense for any issuances of equity instruments to employees is necessary.⁴ Reflecting nominal issuances as outstanding for all historical periods in the computation of earnings per share does not alter that existing responsibility under GAAP.

E. Receivables From Sale of Stock

Facts: Compensation often arises when capital stock is issued or is to be issued to officers or other employees at prices below market.

Question: How should the deferred compensation be presented in the balance sheet?

Interpretive Response: The amounts recorded as deferred compensation should be presented in the balance sheet

as a deduction from stockholders' equity. This is generally consistent with Rule 5-02.30 of Regulation S-X which states that accounts or notes receivable arising from transactions involving the registrant's capital stock should be presented as deductions from stockholders' equity and not as assets.

It should be noted generally that all amounts receivable from officers and directors resulting from sales of stock or from other transactions (other than expense advances or sales on normal trade terms) should be separately stated in the balance sheet irrespective of whether such amounts may be shown as assets or are required to be reported as deductions from stockholders' equity.

The staff will not suggest that a receivable from an officer or director be deducted from stockholders' equity if the receivable was paid in cash prior to the publication of the financial statements and the payment date is stated in a note to the financial statements. However, the staff would consider the subsequent return of such cash payment to the officer or director to be part of a scheme or plan to evade the registration or reporting requirements of the securities laws.

F. Limited Partnerships

Facts: There exist a number of publicly held partnerships having one or more corporate or individual general partners and a relatively larger number of limited partners. There are no specific requirements or guidelines relating to the presentation of the partnership equity accounts in the financial statements. In addition, there are many approaches to the parallel problem of relating the results of operations to the two classes of partnership equity interests.

Question: How should the financial statements of limited partnerships be presented so that the two ownership classes can readily determine their relative participations in both the net assets of the partnership and in the results of its operations?

Interpretive Response: The equity section of a partnership balance sheet should distinguish between amounts ascribed to each ownership class. The equity attributed to the general partners should be stated separately from the equity of the limited partners, and changes in the number of equity units authorized and outstanding should be shown for each ownership class. A statement of changes in partnership equity for each ownership class should be furnished for each period for which an income statement is included.

The income statements of partnerships should be presented in a

manner which clearly shows the aggregate amount of net income (loss) allocated to the general partners and the aggregate amount allocated to the limited partners. The statement of income should also state the results of operations on a per unit basis.

G. Notes and Other Receivables From Affiliates

Facts: The balance sheet of a corporate general partner is often presented in a registration statement. Frequently, the balance sheet of the general partner discloses that it holds notes or other receivables from a parent or another affiliate. Often the notes or other receivables were created in order to meet the "substantial assets" test which the Internal Revenue Service utilizes in applying its "Safe Harbor" doctrine in the classification of organizations for income tax purposes.

Question: How should such notes and other receivables be reported in the balance sheet of the general partner?

Interpretive Response: While these notes and other receivables evidencing a promise to contribute capital are often legally enforceable, they seldom are actually paid. In substance, these receivables are equivalent to unpaid subscriptions receivable for capital shares which Rule 5-02.30 of Regulation S-X requires to be deducted from the dollar amount of capital shares subscribed.

The balance sheet display of these or similar items is not determined by the quality or actual value of the receivable or other asset "contributed" to the capital of the affiliated general partner, but rather by the relationship of the parties and the control inherent in that relationship. Accordingly, in these situations, the receivable must be treated as a deduction from stockholders' equity in the balance sheet of the corporate general partner.

Topic 5: Miscellaneous Accounting

A. Expenses of Offering

Facts: Prior to the effective date of an offering of equity securities, Company Y incurs certain expenses related to the offering.

Question: Should such costs be deferred?

Interpretive Response: Specific incremental costs directly attributable to a proposed or actual offering of securities may properly be deferred and charged against the gross proceeds of the offering. However, management salaries or other general and administrative expenses may not be allocated as costs of the offering and deferred costs of an aborted offering

³ Statement 128 defines potential common stock as "a security or other contract that may entitle its holder to obtain common stock during the reporting period or after the end of the reporting period."

⁴ As prescribed by APB Opinion 25, Statement 123, and related interpretations.

may not be deferred and charged against proceeds of a subsequent offering. A short postponement (up to 90 days) does not represent an aborted offering.

B. Gain or Loss From Disposition of Equipment

Facts: Company A has adopted the policy of treating gains and losses from disposition of revenue producing equipment as adjustments to the current year's provision for depreciation. Company B reflects such gains and losses as a separate item in the statement of income.

Question: Does the staff have any views as to which method is preferable?

Interpretive Response: Gains and losses resulting from the disposition of revenue producing equipment should not be treated as adjustments to the provision for depreciation in the year of disposition, but should be shown as a separate item in the statement of income.

If such equipment is depreciated on the basis of group of composite accounts for fleets of like vehicles, gains (or losses) may be charged (or credited) to accumulated depreciation with the result that depreciation is adjusted over a period of years on an average basis. It should be noted that the latter treatment would not be appropriate for (1) an enterprise (such as an airline) which replaces its fleet on an episodic rather than a continuing basis or (2) an enterprise (such as a car leasing company) where equipment is sold after limited use so that the equipment on hand is both fairly new and carried at amounts closely related to current acquisition cost.

C.1. Deleted by SAB 103

C.2. Deleted by SAB 103

D. Organization and Offering Expenses and Selling Commissions—Limited Partnerships Trading in Commodity Futures

Facts: Partnerships formed for the purpose of engaging in speculative trading in commodity futures contracts sell limited partnership interests to the public and frequently have a general partner who is an affiliate of the partnership's commodity broker or the principal underwriter selling the limited partnership interests. The commodity broker or a subsidiary typically assumes the liability for all or part of the organization and offering expenses and selling commissions in connection with the sale of limited partnership interests. Funds raised from the sale of partnership interests are deposited in a margin account with the commodity broker and are invested in Treasury

Bills or similar securities. The arrangement further provides that interest earned on the investments for an initial period is to be retained by the broker until it has been reimbursed for all or a specified portion of the aforementioned expenses and commissions and that thereafter interest earned accrues to the partnership.

In some instances, there may be no reference to reimbursement of the broker for expenses and commissions to be assumed. The arrangements may provide that all interest earned on investments accrues to the partnership but that commissions on commodity transactions paid to the broker are at higher rates for a specified initial period and at lower rates subsequently.

Question 1: Should the partnership recognize a commitment to reimburse the commodity broker for the organization and offering expenses and selling commissions?

Interpretive Response: Yes. A commitment should be recognized by reducing partnership capital and establishing a liability for the estimated amount of expenses and commissions for which the broker is to be reimbursed.

Question 2: Should the interest income retained by the broker for reimbursement of expenses be recognized as income by the partnership?

Interpretive Response: Yes. All the interest income on the margin account investments should be recognized as accruing to the partnership as earned. The portion of income retained by the broker and not actually realized by the partnership in cash should be applied to reduce the liability for the estimated amount of reimbursable expenses and commissions.

Question 3: If the broker retains all of the interest income for a specified period and thereafter it accrues to the partnership, should an equivalent amount of interest income be reflected on the partnership's financial statements during the specified period?

Interpretive Response: Yes. If it appears from the terms of the arrangement that it was the intent of the parties to provide for full or partial reimbursement for the expenses and commissions paid by the broker, then a commitment to reimbursement should be recognized by the partnership and an equivalent amount of interest income should be recognized on the partnership's financial statements as earned.

Question 4: Under the arrangements where commissions on commodity transactions are at a lower rate after a specified period and there is no

reference to reimbursement of the broker for expenses and commissions, should recognition be given on the partnership's financial statements to a commitment to reimburse the broker for all or part of the expenses and commissions?

Interpretive Response: If it appears from the terms of the arrangement that the intent of the parties was to provide for full or partial reimbursement of the broker's expenses and commissions, then the estimated commitment should be recognized on the partnership's financial statements. During the specified initial period commissions on commodity transactions should be charged to operations at the lower commission rate with the difference applied to reduce the aforementioned commitment.

E. Accounting for Divestiture of a Subsidiary or Other Business Operation

Facts: Company X transferred certain operations (including several subsidiaries) to a group of former employees who had been responsible for managing those operations. Assets and liabilities with a net book value of approximately \$8 million were transferred to a newly formed entity—Company Y—wholly owned by the former employees. The consideration received consisted of \$1,000 in cash and interest bearing promissory notes for \$10 million, payable in equal annual installments of \$1 million each, plus interest, beginning two years from the date of the transaction. The former employees possessed insufficient assets to pay the notes and Company X expected the funds for payments to come exclusively from future operations of the transferred business.

Company X remained contingently liable for performance on existing contracts transferred and agreed to guarantee, at its discretion, performance on future contracts entered into by the newly formed entity. Company X also acted as guarantor under a line of credit established by Company Y.

The nature of Company Y's business was such that Company X's guarantees were considered a necessary predicate to obtaining future contracts until such time as Company Y achieved profitable operations and substantial financial independence from Company X.

Question 1: Company X proposes to account for the transaction as a divestiture, but to defer recognition of gain until the owners of Company Y begin making payments on the promissory notes. Does this proposed accounting treatment reflect the economic substance of the transaction?

Interpretive Response: No. The circumstances are such that the risks of the business have not, in substance, been transferred to Company Y or its owners. In assessing whether the legal transfer of ownership of one or more business operations has resulted in a divestiture for accounting purposes, the principal consideration must be an assessment of whether the risks and other incidents of ownership have been transferred to the buyer with sufficient certainty.

When the facts and circumstances are such that there is a continuing involvement by the seller in the business, recognition of the transaction as a divestiture for accounting purposes is questionable. Such continuing involvement may take the form of effective veto power over major contracts or customers, significant voting power on the board of directors, or other involvement in the continuing operations of the business entailing risks or managerial authority similar to that of ownership.

Other circumstances may also raise questions concerning whether the incidents of ownership have, in substance, been transferred to the buyer. These include:

- Absence of significant financial investment in the business by the buyer, as evidenced, for instance, by a token down payment;
- Repayment of debt which constitutes the principal consideration in the transaction is dependent on future successful operations of the business; or
- The continued necessity for debt or contract performance guarantees on behalf of the business by the seller.

In the above transaction, the seller's continuing involvement in the business and the presence of certain of the other factors cited evidence the fact that the seller has not been divorced from the risks of ownership. Accounting for this proposed transaction as a divestiture—even with deferral of the “gain”—does not reflect its economic substance and therefore is not appropriate.

Further, Company X may need to consider whether it should consolidate Company Y by way of its variable interests pursuant to the provisions of FASB Interpretation 46.

Question 2: If the transaction is not to be treated as a divestiture for accounting purposes, what is the proper accounting treatment?

Interpretive Response: If, in the circumstances surrounding a particular transaction, a determination is made that a legal transfer of business ownership should not be recognized as a divestiture for accounting purposes,

an accounting treatment consistent with that determination is required. In this instance, if Company Y is not consolidated by Company X, the assets and liabilities of the business which were the subject of the transaction should be segregated in the balance sheet of the selling entity under captions such as: “Assets of business transferred under contractual arrangements (notes receivable),” and “Liabilities of business transferred” or similar captions which appropriately convey the distinction between the legal form of the transaction and its accounting treatment.

A note to the financial statements should describe the nature of the legal arrangements, relevant financing and other details and the accounting treatment.

Where, as in this instance, realization of the sale price is wholly or principally dependent on the operating results of the business operations which were the subject of the transaction, the uncertainty associated with such realization should be reflected in the financial statements of the seller. Thus, absent a deterioration in the business, any operating losses of the divested business should be considered the best evidence of a change in valuation of the business in a manner somewhat analogous to equity accounting for an investment in common stock.¹ If the business suffered a loss during its initial period of operations after the transaction, that loss should be reflected in the financial statements of the seller by recording a valuation allowance and a corresponding charge to income. The amount of the valuation allowance (absent unusual circumstances) would be at least the amount of the loss attributable to the business. Other evidence, however (such as a question as to the ability of the business to continue as a going concern), might require that a higher valuation allowance be established.

This accounting treatment should be continued for each period until either:

1. The net assets of the business have been written down to zero (or a net liability recognized in accordance with GAAP); or

¹ The staff recognizes that APB Opinion 18 is specifically applicable only to the use of the equity method of accounting for investments in common stock. The principles enunciated in Opinion 18 are also relevant in these particular circumstances, however, notably paragraph 12, which states, in pertinent part: “The equity method tends to be most appropriate if an investment enables the investor to influence the operating of financial decisions of the investee. The investor then has a degree of responsibility for the return on its investment, and it is appropriate to include in the results of operations of the investor its share of the earnings or losses of the investee.”

2. Circumstances have changed sufficiently that it has become appropriate to recognize the transaction as a divestiture.

In the latter instance, it would normally also be appropriate to recapture any asset balance remaining on the balance sheet of the seller in keeping with the changed circumstances, e.g., “Notes receivable.”

In the case where the business reports net income, such net income should not be recorded by the former owner, because the rewards of ownership (but not the risks) have been passed to Company Y. Any payments received on obligations of the buyer arising out of the transaction should be treated as a reduction of the carrying value of the segregated assets of the business.

Question 3: Should Company X recognize interim (quarterly) losses of the business even if it is projected that it will have a profit for the full year?

Interpretive Response: Yes. However, for quarters for which the business has net income, such net income may be recognized by Company X to the extent of any cumulative quarterly losses within the same fiscal year. Similarly, quarterly losses of the business need not be recognized by Company X except to the extent that they exceed any cumulative quarterly net income within the same fiscal year. Disclosure of this accounting treatment should be made in the notes to Company X's interim financial statements.

Question 4: If the accounting treatment described above is applied to the transaction, when should a gain or loss on the transaction be recognized?

Interpretive Response: Whether or not the transaction is treated as a divestiture for accounting purposes, GAAP require that losses on such transactions be recognized. When it is determined that no divestiture should be recognized for accounting purposes, it follows that gain should not be recognized until:

1. The circumstances precluding treatment of the transaction as a divestiture have changed sufficiently to permit such recognition; and,

2. Any major uncertainties as to ultimate realization of profit have been removed, that is, the consideration received in the transaction can be reasonably evaluated.

The authoritative literature indicates that:

Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured.²

² ARB 43, Chapter 1, Section A. This passage is also quoted in paragraph 12 of APB Opinion 10,

The considerations discussed above regarding recognition of a divestiture for accounting purposes are also of importance in reaching a determination as to whether or not collection of the sale price is reasonably assured and profit recognition is therefore appropriate. In addition, circumstances such as the following tend to raise questions as to the propriety of profit recognition at any given time subsequent to the transaction:

1. Evidence of financial weakness of the buyer.

2. Substantial uncertainty as to the amount of future costs and expenses to be incurred by the seller.

3. Substantial uncertainty as to the amount of proceeds to be realized because of the form of consideration received; e.g., nonrecourse debt, notes with optional settlement provisions, purchaser's stock, or other nonmonetary consideration which may be of indeterminable value.

(Where satisfaction of the buyer's obligations to the seller remains dependent on earnings of the business divested, it will frequently be appropriate for the seller to continue to measure the uncertainty of ultimate collection by the operating losses of the business.)

The degree of uncertainty surrounding ultimate realization of the consideration is a matter which must be evaluated in the light of the attendant circumstances each time realization is evaluated. The degree of uncertainty is enhanced, however, by the presence of any of the factors referred to above, and such factors must be considered in reaching a determination with respect to recognition of gain.

F. Accounting Changes Not Retroactively Applied Due to Immateriality

Facts: A registrant is required to adopt an accounting principle by means of restatement of prior periods' financial statements. However, the registrant determines that the accounting change does not have a material effect on prior periods' financial statements and, accordingly, decides not to restate such financial statements.

Question: In these circumstances, is it acceptable to adjust the beginning balance of retained earnings of the

period in which the change is made for the cumulative effect of the change on the financial statements of prior periods?

Interpretive Response: No. If prior periods are not restated, the cumulative effect of the change should be included in the statement of income for the period in which the change is made (not to be reported as a cumulative effect adjustment in the manner of APB Opinion 20). Even in cases where the total cumulative effect is not significant, the staff believes that the amount should be reflected in the results of operations for the period in which the change is made. However, if the cumulative effect is material to current operations or to the trend of the reported results of operations, then the individual income statements of the earlier years should be retroactively adjusted.

This position is consistent with the requirements of Statement 5 and Statement 13, which indicate that "the cumulative effect [of the change] on retained earnings at the beginning of the earliest period restated shall be included in determining net income of that period."

G. Transfers of Nonmonetary Assets by Promoters or Shareholders

Facts: Nonmonetary assets are exchanged by promoters or shareholders for all or part of a company's common stock just prior to or contemporaneously with a first-time public offering.

Question: Since paragraph 4 of APB Opinion 29 states that Opinion 29 is not applicable to transactions involving the acquisition of nonmonetary assets or services on issuance of the capital stock of an enterprise, what value should be ascribed to the acquired assets by the company?

Interpretive Response: The staff believes that transfers of nonmonetary assets to a company by its promoters or shareholders in exchange for stock prior to or at the time of the company's initial public offering normally should be recorded at the transferors' historical cost basis determined under GAAP.

The staff will not always require that predecessor cost be used to value nonmonetary assets received from an enterprise's promoters or shareholders. However, deviations from this policy have been rare applying generally to situations where the fair value of either the stock issued¹ or assets acquired is objectively measurable and the transferor's stock ownership following the transaction was not so significant

that the transferor had retained a substantial indirect interest in the assets as a result of stock ownership in the company.

H. Accounting for Sales of Stock by a Subsidiary

Facts: The registrant owns 95% of its subsidiary's stock. The subsidiary sells its unissued shares in a public offering, which decreases the registrant's ownership of the subsidiary from 95% to 90%. The offering price per share exceeds the registrant's carrying amount per share of subsidiary stock.

Question 1: When an offering takes the form of a subsidiary's direct sale of its unissued shares, will the staff permit the amount in excess of the parent's carrying value to be reflected as a gain in the consolidated income statement of the parent?

Interpretive Response: Yes, in some circumstances. Although the staff at one time insisted that such transactions be accounted for as capital transactions in the consolidated financial statements, it has reconsidered its views on this matter with respect to certain of these transactions where the sale of such shares by a subsidiary is not a part of a broader corporate reorganization contemplated or planned by the registrant. In situations where no other such capital transactions are contemplated, the staff has determined that it will accept accounting treatment for such transactions that is in accordance with the Advisory Conclusions in paragraph 30 of the June 3, 1980 Issues Paper, "Accounting in Consolidation for Issuances of a Subsidiary's Stock." The staff believes that this issues paper should provide appropriate guidance on this matter until the FASB addresses this issue as a part of its project on Accounting for the Reporting Entity, including Consolidations, the Equity Method, and Related Matters.

Question 2: What is meant by the phrase "broader corporate reorganization contemplated or planned by the registrant" and are there other situations where the staff has objected to gain recognition?

Interpretive Response: The staff believes that gain recognition is not appropriate in situations where subsequent capital transactions are contemplated that raise concerns about the likelihood of the registrant realizing that gain, such as where the registrant intends to spin-off its subsidiary to shareholders or where reacquisition of shares is contemplated at the time of issuance. The staff will presume that repurchases were contemplated at the date of issuance in those situations

footnote 8, which states, in pertinent part: "The Board recognizes that there are exceptional cases where receivables are collectible over an extended period of time and, because of the terms of the transactions or other conditions, there is no reasonable basis for estimating the degree of collectibility. When such circumstances exist, and as long as they exist, either the installment method or the cost recovery method of accounting may be used."

¹ Estimating the fair value of the common stock issued, however, is not appropriate when the stock is closely held and/or seldom or ever traded.

where shares are repurchased within one year of issuance or where a specific plan existed to repurchase shares at the time shares were issued. In addition, the staff believes that realization is not assured where the subsidiary is a newly-formed, non-operating entity; a research and development, start-up or development stage company; an entity whose ability to continue in existence is in question; or other similar circumstances. In those situations, the staff believes that the change in the parent company's proportionate share of subsidiary equity resulting from the additional equity raised by the subsidiary should be accounted for as an equity transaction in consolidation. Gain deferral is not appropriate.

Question 3: In the staff's opinion, may gain be recognized for issuances of subsidiary stock in situations other than sales of unissued shares in a public offering?

Interpretive Response: Yes. The staff believes that gain recognition is acceptable in situations other than sales of unissued shares in a public offering as long as the value of the proceeds can be objectively determined. With respect to issuances of stock options, warrants, and convertible and other similar securities, gain should not be recognized before exercise or conversion into common stock, and then only provided that realization of the gain is reasonably assured (see Question 2 above) at the time of such exercise or conversion.

Question 4: Will repurchasing shares of a subsidiary's stock affect the potential for gain recognition by the registrant in consolidation for subsequent issuances of that subsidiary's stock?¹

Interpretive Response: Yes. Where previous gains have been recognized in consolidation on issuances of a subsidiary's stock and shares of the subsidiary are subsequently repurchased by the subsidiary, its parent or any member of the consolidated group, gain recognition should not occur on issuances subsequent to the date of a repurchase until such time as shares have been issued in an amount equivalent to the number of repurchased shares. The staff views such transactions as analogous to treasury stock transactions from the standpoint of the consolidated entity that should not result in recognition of gains or losses.

Question 5: May registrants selectively apply the guidance in the

SAB by recognizing the impact of certain issuances by a subsidiary in the income statement and other issuances as equity transactions?

Interpretive Response: No. The staff believes that income statement treatment in consolidation for issuances of stock by a subsidiary represents a choice among alternative accounting methods and, therefore, must be applied consistently to all stock transactions that meet the conditions for income statement treatment set forth herein for any subsidiary. If a registrant recognizes gains on issuances of stock by a subsidiary, thus adopting income statement recognition as its accounting policy, then it must also recognize losses for stock issuances by that or any other subsidiary that result in decreases in its proportionate share of the dollar amount of the subsidiary's equity. Regardless of the method of accounting selected, when a subsidiary issues securities at prices less than the parent's carrying value per share, the registrant must assess whether the investment has been impaired, in which case a provision should be reflected in the income statement.

Question 6: How should the registrant disclose the accounting for issuances of a subsidiary's stock in the consolidated financial statements?

Interpretive Response: The staff believes that gains (or losses) arising from issuances by a subsidiary of its own stock, if recorded in income by the parent, should be presented as a separate line item in the consolidated income statement without regard to materiality and clearly be designated as non-operating income. An appropriate description of the transaction should be included in the notes to the financial statements, as further described below.

The accounting method adopted by the registrant for issuances of a subsidiary's stock should be disclosed in its accounting policy footnote and consistently applied (See Question 5). The staff believes that the registrant also should include a separate footnote that describes issuances of subsidiary stock that have occurred during all periods presented. This footnote should clearly describe the transaction, the identification of the subsidiary and nature of its operations, the number of shares issued, the price per share and the total dollar amount and nature of consideration received, and the percentage ownership of the parent both before and after the transaction. Additionally, the registrant should clearly state whether deferred income taxes have been provided on gains recognized and, if no provision has been recorded, a clear explanation of the

reasons. Finally, the staff expects registrants to include disclosure in their Management Discussion and Analysis of the impact of specific transactions that have occurred and the likelihood of similar transactions occurring in future years.

I. Deleted by SAB 70

J. Push Down Basis of Accounting Required in Certain Limited Circumstances

Facts: Company A (or Company A and related persons) acquired substantially all of the common stock of Company B in one or a series of purchase transactions.

Question 1: Must Company B's financial statements presented in either its own or Company A's subsequent filings with the Commission reflect the new basis of accounting arising from Company A's acquisition of Company B when Company B's separate corporate entity is retained?

Interpretive Response: Yes. The staff believes that purchase transactions that result in an entity becoming substantially wholly owned (as defined in Rule 1-02(aa) of Regulation S-X) establish a new basis of accounting for the purchased assets and liabilities.

When the form of ownership is within the control of the parent the basis of accounting for purchased assets and liabilities should be the same regardless of whether the entity continues to exist or is merged into the parent's operations. Therefore, Company A's cost of acquiring Company B should be "pushed down," i.e., used to establish a new accounting basis in Company B's separate financial statements.¹

Question 2: What is the staff's position if Company A acquired less than substantially all of the common stock of Company B or Company B had publicly held debt or preferred stock at the time Company B became wholly owned?

Interpretive Response: The staff recognizes that the existence of outstanding public debt, preferred stock or a significant minority interest in a subsidiary might impact the parent's ability to control the form of ownership. Although encouraging its use, the staff generally does not insist on the application of push down accounting in these circumstances.

¹ The Task Force on Consolidation Problems, Accounting Standards Division of the American Institute of Certified Public Accountants issued a paper entitled "Push Down" Accounting, October 30, 1979. This paper addresses the issues relating to "push down" accounting, cites authoritative literature and indicates that a substantial change in ownership justifies a new basis of accounting.

¹ This question and interpretive response assume that the repurchases were not contemplated at the time of earlier gain recognition. See Question 2.

Question 3: Company A borrows funds to acquire substantially all of the common stock of Company B. Company B subsequently files a registration statement in connection with a public offering of its stock or debt.² Should Company B's new basis ("push down") financial statements include Company A's debt related to its purchase of Company B?

Interpretive Response: The staff believes that Company A's debt,³ related interest expense, and allocable debt issue costs should be reflected in Company B's financial statements included in the public offering (or an initial registration under the Exchange Act) if: (1) Company B is to assume the debt of Company A, either presently or in a planned transaction in the future; (2) the proceeds of a debt or equity offering of Company B will be used to retire all or a part of Company A's debt; or (3) Company B guarantees or pledges its assets as collateral for Company A's debt.

Other relationships may exist between Company A and Company B, such as the pledge of Company B's stock as collateral for Company A's debt.⁴ While in this latter situation, it may be clear that Company B's cash flows will service all or part of Company A's debt, the staff does not insist that the debt be reflected in Company B's financial statements providing there is full and prominent disclosure of the relationship between Companies A and B and the actual or potential cash flow commitment. In this regard, the staff believes that Statements 5 and 57 as well as Interpretation 45 require sufficient disclosure to allow users of Company B's financial statements to fully understand the impact of the relationship on Company B's present and future cash flows. Rule 4-08(e) of Regulation S-X also requires disclosure of restrictions which limit the payment of dividends. Therefore, the staff believes that the equity section of Company B's balance sheet and any pro forma financial information and

capitalization tables should clearly disclose that this arrangement exists.⁵

Regardless of whether the debt is reflected in Company B's financial statements, the notes to Company B's financial statements should generally disclose, at a minimum: (1) The relationship between Company A and Company B; (2) a description of any arrangements that result in Company B's guarantee, pledge of assets⁶ or stock, etc. that provides security for Company A's debt; (3) the extent (in the aggregate and for each of the five years subsequent to the date of the latest balance sheet presented) to which Company A is dependent on Company B's cash flows to service its debt and the method by which this will occur; and (4) the impact of such cash flows on Company B's ability to pay dividends or other amounts to holders of its securities.

Additionally, the staff believes Company B's Management's Discussion and Analysis of Financial Condition and Results of Operations should discuss any material impact of its servicing of Company A's debt on its own liquidity pursuant to Item 303(a)(1) of Regulation S-K.

K. Deleted by SAB 95

L. LIFO Inventory Practices

Facts: On November 30, 1984, AcSEC and its Task Force on LIFO Inventory Problems (task force) issued a paper, "Identification and Discussion of Certain Financial Accounting and Reporting Issues Concerning LIFO Inventories." This paper identifies and discusses certain financial accounting and reporting issues related to the last-in, first-out (LIFO) inventory method for which authoritative accounting literature presently provides no definitive guidance. For some issues, the task force's advisory conclusions recommend changes in current practice to narrow the diversity which the task force believes exists. For other issues, the task force's advisory conclusions recommend that current practice should be continued for financial reporting purposes and that additional accounting

guidance is unnecessary. Except as otherwise noted in the paper, AcSEC generally supports the task force's advisory conclusions. As stated in the issues paper, "Issues papers of the AICPA's accounting standards division are developed primarily to identify financial accounting and reporting issues the division believes need to be addressed or clarified by the Financial Accounting Standards Board." On February 6, 1985, the FASB decided not to add to its agenda a narrow project on the subject of LIFO inventory practices.

Question 1: What is the SEC staff's position on the issues paper?

Interpretive Response: In the absence of existing authoritative literature on LIFO accounting, the staff believes that registrants and their independent accountants should look to the paper for guidance in determining what constitutes acceptable LIFO accounting practice.¹ In this connection, the staff considers the paper to be an accumulation of existing acceptable LIFO accounting practices which does not establish any new standards and does not diverge from GAAP.

The staff also believes that the advisory conclusions recommended in the issues paper are generally consistent with conclusions previously expressed by the Commission, such as:

1. Pooling—paragraph 4-6 of the paper discusses LIFO inventory pooling and concludes "establishing separate pools with the principal objective of facilitating inventory liquidations is unacceptable." In Accounting and Auditing Enforcement Release 35, August 13, 1984, the Commission stated that it believes that the Company improperly realigned its LIFO pools in such a way as to maximize the likelihood and magnitude of LIFO liquidations and thus, overstated net income.

2. New Items—paragraph 4-27 of the paper discusses determination of the cost of new items and concludes "if the double extension or an index technique is used, the objective of LIFO is

² The guidance in this SAB should also be considered for Company B's separate financial statements included in its public offering following Company B's spin-off or carve-out from Company A.

³ The guidance in this SAB should also be considered where Company A has financed the acquisition of Company B through the issuance of mandatory redeemable preferred stock.

⁴ The staff does not believe Company B's financial statements must reflect the debt in this situation because in the event of default on the debt by Company A, the debt holder(s) would only be entitled to B's stock held by Company A. Other equity or debt holders of Company B would retain their priority with respect to the net assets of Company B.

⁵ For example, the staff has noted that certain registrants have indicated on the face of such financial statements (as part of the stockholder's equity section) the actual or potential financing arrangement and the registrant's intent to pay dividends to satisfy its parent's debt service requirements. The staff believes such disclosures are useful to highlight the existence of arrangements that could result in the use of Company B's cash to service Company A's debt.

⁶ A material asset pledge should be clearly indicated on the face of the balance sheet. For example, if all or substantially all of the assets are pledged, the "assets" and "total assets" captions should include parenthetically: "pledged for parent company debt—See Note X."

¹ In ASR 293 (July 2, 1981) see Financial Reporting Codification § 205, the Commission expressed its concerns about the inappropriate use of Internal Revenue Service (IRS) LIFO practices for financial statement preparation. Because the IRS amended its regulations concerning the LIFO conformity rule on January 13, 1981, allowing companies to apply LIFO differently for financial reporting purposes than for tax purposes, the Commission strongly encouraged registrants and their independent accountants to examine their financial reporting LIFO practices. In that release, the Commission acknowledged the "task force which has been established by AcSEC to accumulate information about [LIFO] application problems" and noted that "This type of effort, in addition to self-examination [of LIFO practices] by individual registrants, is appropriate * * *

achieved by reconstructing the base year cost of new items added to existing pools." In ASR 293, the Commission stated that when the effects of inflation on the cost of new products are measured by making a comparison with current cost as the base-year cost, rather than a reconstructed base-year cost, income is improperly increased.

Question 2: If a registrant utilizes a LIFO practice other than one recommended by an advisory conclusion in the issues paper, must the registrant change its practice to one specified in the paper?

Interpretive Response: Now that the issues paper is available, the staff believes that a registrant and its independent accountants should re-examine previously adopted LIFO practices and compare them to the recommendations in the paper. In the event that the registrant and its independent accountants conclude that the registrant's LIFO practices are preferable in the circumstances, they should be prepared to justify their position in the event that a question is raised by the staff.

Question 3: If a registrant elects to change its LIFO practices to be consistent with the guidance in the issues paper and discloses such changes in accordance with APB Opinion 20 will the registrant be requested by the staff to explain its past practices and its justification for those practices?

Interpretive Response: The staff does not expect to routinely raise questions about changes in LIFO practices which are made to make a company's accounting consistent with the recommendations in the issues paper.

M. Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities

Facts: Paragraph 16 of Statement 115 specifies that "[f]or individual securities classified as either available-for-sale or held-to-maturity, an enterprise shall determine whether a decline in fair value below the amortized cost basis is other than temporary * * * If the decline in fair value is judged to be other than temporary, the cost basis of the individual security shall be written down to fair value as a new cost basis and the amount of the write-down shall be included in earnings (that is, accounted for as a realized loss)."

Statement 115 does not define the phrase "other than temporary." In applying this guidance to its own situation, Company A has interpreted "other than temporary" to mean permanent impairment. Therefore, because Company A's management has not been able to determine that its

investment in Company B is permanently impaired, no realized loss has been recognized even though the market price of B's shares is currently less than one-third of A's average acquisition price.

Question: Does the staff believe that the phrase "other than temporary" should be interpreted to mean "permanent"?

Interpretive Response: No. The staff believes that the FASB consciously chose the phrase "other than temporary" because it did not intend that the test be "permanent impairment," as has been used elsewhere in accounting practice.¹

The value of investments in marketable securities classified as either available-for-sale or held-to-maturity may decline for various reasons. The market price may be affected by general market conditions which reflect prospects for the economy as a whole or by specific information pertaining to an industry or an individual company. Such declines require further investigation by management. Acting upon the premise that a write-down may be required, management should consider all available evidence to evaluate the realizable value of its investment.

There are numerous factors to be considered in such an evaluation and their relative significance will vary from case to case. The staff believes that the following are only a few examples of the factors which, individually or in combination, indicate that a decline is other than temporary and that a write-down of the carrying value is required:

- a. The length of the time and the extent to which the market value has been less than cost;
- b. The financial condition and near-term prospects of the issuer, including any specific events which may influence the operations of the issuer such as changes in technology that may impair the earnings potential of the investment or the discontinuance of a segment of the business that may affect the future earnings potential; or
- c. The intent and ability of the holder to retain its investment in the issuer for

¹Footnote 4 to Statement 115 refers to this SAB for a discussion of considerations applicable to a determination as to whether a decline in market value below cost, at a particular point in time, is other than temporary. FASB's implementation guide "A Guide to Implementation of Statement 115 on Accounting for Certain Investments in Debt and Equity Securities," SAS 92, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities," AICPA Audit Guide, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities," and EITF Topic D-44 also address issues related to the determination of whether a decline in fair value of an investment security is other than temporary.

a period of time sufficient to allow for any anticipated recovery in market value.

Unless evidence exists to support a realizable value equal to or greater than the carrying value of the investment, a write-down to fair value accounted for as a realized loss should be recorded. In accordance with the guidance of paragraph 16 of Statement 115, such loss should be recognized in the determination of net income of the period in which it occurs and the written down value of the investment in the company becomes the new cost basis of the investment.

N. Discounting by Property-Casualty Insurance Companies

Facts: A registrant which is an insurance company discounts certain unpaid claims liabilities related to short-duration¹ insurance contracts for purposes of reporting to state regulatory authorities, using discount rates permitted or prescribed by those authorities ("statutory rates") which approximate 3½ percent. The registrant follows the same practice in preparing its financial statements in accordance with GAAP. It proposes to change for GAAP purposes, to using a discount rate related to the historical yield on its investment portfolio ("investment related rate") which is represented to approximate 7 percent, and to account for the change as a change in accounting estimate, applying the investment related rate to claims settled in the current and subsequent years while the statutory rate would continue to be applied to claims settled in all prior years.

Question 1: What is the staff's position with respect to discounting claims liabilities related to short-duration insurance contracts?

Interpretive Response: The staff is aware of efforts by the accounting profession to assess the circumstances under which discounting may be appropriate in financial statements. Pending authoritative guidance resulting from those efforts however, the staff will raise no objection if a registrant follows a policy for GAAP reporting purposes of:

- Discounting liabilities for unpaid claims and claim adjustment expenses at the same rates that it uses for reporting to state regulatory authorities with respect to the same claims liabilities, or

¹ The term "short-duration" refers to the period of coverage (see statement 60, paragraph 7), not the period that the liabilities are expected to be outstanding.

- Discounting liabilities with respect to settled claims under the following circumstances:

- The payment pattern and ultimate cost are fixed and determinable on an individual claim basis, and
- The discount rate used is reasonable on the facts and circumstances applicable to the registrant at the time the claims are settled.

Question 2: Does the staff agree with the registrant's proposal that the change from a statutory rate to an investment related rate be accounted for as a change in accounting estimate?

Interpretive Response: No. The staff believes that such a change involves a change in the method of applying an accounting principle, *i.e.*, the method of selecting the discount rate was changed. The staff therefore believes that the registrant should reflect the cumulative effect of the change in accounting by applying the new selection method retroactively to liabilities for claims settled in all prior years, in accordance with the requirements of APB Opinion 20. Initial adoption of discounting for GAAP purposes would be treated similarly. In either case, in addition to the disclosures required by APB Opinion 20 concerning the change in accounting principle, a preferability letter from the registrant's independent accountant is required.

O. Research and Development Arrangements

Facts: Statement 68 paragraph 7 states that conditions other than a written agreement may exist which create a presumption that the enterprise will repay the funds provided by other parties under a research and development arrangement. Paragraph 8(c) lists as one of those conditions the existence of a "significant related party relationship" between the enterprise and the parties funding the research and development.

Question 1: What does the staff consider a "significant related party relationship" as that term is used in paragraph 8(c) of Statement 68?

Interpretive Response: The staff believes that a significant related party relationship exists when 10 percent or more of the entity providing the funds is owned by related parties.¹ In unusual circumstances, the staff may also question the appropriateness of treating a research and development arrangement as a contract to perform service for others at the less than 10 percent level. In reviewing these matters

the staff will consider, among other factors, the percentage of the funding entity owned by the related parties in relationship to their ownership in and degree of influence or control over the enterprise receiving the funds.

Question 2: Paragraph 7 of Statement 68 states that the presumption of repayment "can be overcome only by substantial evidence to the contrary." Can the presumption be overcome by evidence that the funding parties were assuming the risk of the research and development activities since they could not reasonably expect the enterprise to have resources to repay the funds based on its current and projected future financial condition?

Interpretive Response: No. Paragraph 5 of Statement 68 specifically indicates that the enterprise "may settle the liability by paying cash, by issuing securities, or by some other means." While the enterprise may not be in a position to pay cash or issue debt, repayment could be accomplished through the issuance of stock or various other means. Therefore, an apparent or projected inability to repay the funds with cash (or debt which would later be paid with cash) does not necessarily demonstrate that the funding parties were accepting the entire risks of the activities.

P. Restructuring Charges

1. Deleted by SAB 103

2. Deleted by SAB 103

3. Income Statement Presentation of Restructuring Charges

Facts: Restructuring charges often do not relate to a separate component of the entity, and, as such, they would not qualify for presentation as losses on the disposal of a discontinued operation. Additionally, since the charges are not both unusual and infrequent¹ they are not presented in the income statement as extraordinary items.

Question 1: May such restructuring charges be presented in the income statement as a separate caption after income from continuing operations before income taxes (*i.e.*, preceding income taxes and/or discontinued operations)?

Interpretive Response: No. Paragraph 26 of APB Opinion 30 states that items that do not meet the criteria for classification as an extraordinary item should be reported as a component of income from continuing operations.²

¹ See APB Opinion 30, paragraph 20.

² Paragraph 26 of APB Opinion 30 further provides that such items should not be reported on the income statement net of income taxes or in any manner that implies that they are similar to extraordinary items.

Neither Opinion 30 nor Rule 5-03 of Regulation S-X contemplate a category in between continuing and discontinued operations. Accordingly, the staff believes that restructuring charges should be presented as a component of income from continuing operations, separately disclosed if material. Furthermore, the staff believes that a separately presented restructuring charge should not be preceded by a subtotal representing "income from continuing operations before restructuring charge" (whether or not it is so captioned). Such a presentation would be inconsistent with the intent of Opinion 30.

Question 2: Some registrants utilize a classified or "two-step" income statement format (*i.e.*, one which presents operating revenues, expenses and income followed by other income and expense items). May a charge which relates to assets or activities for which the associated revenues and expenses have historically been included in operating income be presented as an item of "other expense" in such an income statement?

Interpretive Response: No. The staff believes that the proper classification of a restructuring charge depends on the nature of the charge and the assets and operations to which it relates. Therefore, charges which relate to activities for which the revenues and expenses have historically been included in operating income should generally be classified as an operating expense, separately disclosed if material. Furthermore, when a restructuring charge is classified as an operating expense, the staff believes that it is generally inappropriate to present a preceding subtotal captioned or representing operating income before restructuring charges. Such an amount does not represent a measurement of operating results under GAAP.

Conversely, charges relating to activities previously included under "other income and expenses" should be similarly classified, also separately disclosed if material.

Question 3: Is it permissible to disclose the effect on net income and earnings per share of such a restructuring charge?

Interpretive Response: Discussions in MD&A and elsewhere which quantify the effects of unusual or infrequent items on net income and earnings per share are beneficial to a reader's understanding of the financial statements and are therefore acceptable.

MD&A also should discuss the events and decisions which gave rise to the restructuring, the nature of the charge and the expected impact of the

¹ Related parties as used herein are as defined in paragraph 24 of Statement 57.

restructuring on future results of operations, liquidity and sources and uses of capital resources.

4. Disclosures

Beginning with the period in which the exit plan is initiated, Statement 146 requires disclosure, in *all* periods, including *interim* periods, until the exit plan is completed, of the following:

a. A description of the exit or disposal activity, including the facts and circumstances leading to the expected activity and the expected completion date

b. For each major type of cost associated with the activity (for example, one-time termination benefits, contract termination costs, and other associated costs):

(1) The total amount expected to be incurred in connection with the activity, the amount incurred in the period, and the cumulative amount incurred to date

(2) A reconciliation of the beginning and ending liability balances showing separately the changes during the period attributable to costs incurred and charged to expense, costs paid or otherwise settled, and any adjustments to the liability with an explanation of the reason(s) therefor

c. The line item(s) in the income statement or the statement of activities in which the costs in (b) above are aggregated

d. For each reportable segment, the total amount of costs expected to be incurred in connection with the activity, the amount incurred in the period, and the cumulative amount incurred to date, net of any adjustments to the liability with an explanation of the reason(s) therefor

e. If a liability for a cost associated with the activity is not recognized because fair value cannot be reasonably estimated, that fact and the reasons therefor.

Question: What specific disclosures about restructuring charges has the staff requested to fulfill the disclosure requirements of Statement 146 and MD&A?

Interpretive Response: The staff often has requested greater disaggregation and more precise labeling when exit and involuntary termination costs are grouped in a note or income statement line item with items unrelated to the exit plan. For the reader's understanding, the staff has requested that discretionary, or decision-dependent, costs of a period, such as exit costs, be disclosed and explained in MD&A separately. Also to improve transparency, the staff has requested disclosure of the nature and amounts of additional types of exit costs and other

types of restructuring charges¹ that appear quantitatively or qualitatively material, and requested that losses relating to asset impairments be identified separately from charges based on estimates of future cash expenditures.

The staff frequently reminds registrants that in periods subsequent to the initiation date that material changes and activity in the liability balances of each significant type of exit cost and involuntary employee termination benefits² (either as a result of expenditures or changes in/reversals of estimates or the fair value of the liability) should be disclosed in the footnotes to the interim and annual financial statements and discussed in MD&A. In the event a company recognized liabilities for exit costs and involuntary employee termination benefits relating to multiple exit plans, the staff believes presentation of separate information for each individual exit plan that has a material effect on the balance sheet, results of operations or cash flows generally is appropriate.

For material exit or involuntary employee termination costs related to an acquired business, the staff has requested disclosure in either MD&A or the financial statements of:

a. When the registrant began formulating exit plans for which accrual may be necessary,

b. The types and amounts of liabilities recognized for exit costs and involuntary employee termination benefits and included in the acquisition cost allocation, and

c. Any unresolved contingencies or purchase price allocation issues and the types of additional liabilities that may result in an adjustment of the acquisition cost allocation.

The staff has noted that the economic or other events that cause a registrant to consider and/or adopt an exit plan or that impair the carrying amount of assets, generally occur over time. Accordingly, the staff believes that as those events and the resulting trends and uncertainties evolve, they often will meet the requirement for disclosure pursuant to the Commission's MD&A

¹ Examples of common components of exit costs and other types of restructuring charges which should be considered for separate disclosure include, but are not limited to, involuntary employee terminations and related costs, changes in valuation of current assets such as inventory writedowns, long term asset disposals, adjustments for warranties and product returns, leasehold termination payments, and other facility exit costs, among others.

² The staff would expect similar disclosures for employee termination benefits whether those costs have been recognized pursuant to Statement 88, 112, or 146.

rules prior to the period in which the exit costs and liabilities are recorded pursuant to GAAP. Whether or not currently recognizable in the financial statements, material exit or involuntary termination costs that affect a known trend, demand, commitment, event, or uncertainty to management, should be disclosed in MD&A. The staff believes that MD&A should include discussion of the events and decisions which gave rise to the exit costs and exit plan, and the likely effects of management's plans on financial position, future operating results and liquidity unless it is determined that a material effect is not reasonably likely to occur. Registrants should identify the periods in which material cash outlays are anticipated and the expected source of their funding. Registrants should also discuss material revisions to exit plans, exit costs, or the timing of the plan's execution, including the nature and reasons for the revisions.

The staff believes that the expected effects on future earnings and cash flows resulting from the exit plan (for example, reduced depreciation, reduced employee expense, etc.) should be quantified and disclosed, along with the initial period in which those effects are expected to be realized. This includes whether the cost savings are expected to be offset by anticipated increases in other expenses or reduced revenues. This discussion should clearly identify the income statement line items to be impacted (for example, cost of sales; marketing; selling, general and administrative expenses; etc.). In later periods if actual savings anticipated by the exit plan are not achieved as expected or are achieved in periods other than as expected, MD&A should discuss that outcome, its reasons, and its likely effects on future operating results and liquidity.

The staff often finds that, because of the discretionary nature of exit plans and the components thereof, presenting and analyzing material exit and involuntary termination charges in tabular form, with the related liability balances and activity (e.g., beginning balance, new charges, cash payments, other adjustments with explanations, and ending balances) from balance sheet date to balance sheet date, is necessary to explain fully the components and effects of significant restructuring charges. The staff believes that such a tabular analysis aids a financial statement user's ability to disaggregate the restructuring charge by income statement line item in which the costs would have otherwise been recognized, absent the restructuring plan, (for

example, cost of sales; selling, general, and administrative; etc.).

Q. Increasing Rate Preferred Stock

Facts: A registrant issues Class A and Class B nonredeemable preferred stock¹ on 1/1/X1. Class A, by its terms, will pay no dividends during the years 20X1 through 20X3. Class B, by its terms, will pay dividends at annual rates of \$2, \$4 and \$6 per share in the years 20X1, 20X2 and 20X3, respectively. Beginning in the year 20X4 and thereafter as long as they remain outstanding, each instrument will pay dividends at an annual rate of \$8 per share. In all periods, the scheduled dividends are cumulative.

At the time of issuance, eight percent per annum was considered to be a market rate for dividend yield on Class A, given its characteristics other than scheduled cash dividend entitlements (voting rights, liquidation preference, etc.), as well as the registrant's financial condition and future economic prospects. Thus, the registrant could have expected to receive proceeds of approximately \$100 per share for Class A if the dividend rate of \$8 per share (the "perpetual dividend") had been in effect at date of issuance. In consideration of the dividend payment terms, however, Class A was issued for proceeds of \$79 3/8 per share. The difference, \$20 5/8, approximated the value of the absence of \$8 per share dividends annually for three years, discounted at 8%.

The issuance price of Class B shares was determined by a similar approach, based on the terms and characteristics of the Class B shares.

Question 1: How should preferred stocks of this general type (referred to as "increasing rate preferred stocks") be reported in the balance sheet?

Interpretive Response: As is normally the case with other types of securities, increasing rate preferred stock should be recorded initially at its fair value on date of issuance. Thereafter, the carrying amount should be increased periodically as discussed in the Interpretive Response to Question 2.

Question 2: Is it acceptable to recognize the dividend costs of increasing rate preferred stocks according to their stated dividend schedules?

Interpretive Response: No. The staff believes that when consideration received for preferred stocks reflects expectations of future dividend streams, as is normally the case with cumulative preferred stocks, any discount due to an absence of dividends (as with Class A) or gradually increasing dividends (as with Class B) for an initial period represents prepaid, unstated dividend cost.² Recognizing the dividend cost of these instruments according to their stated dividend schedules would report Class A as being cost-free, and would report the cost of Class B at less than its effective cost, from the standpoint of common stock interests (i.e., for purposes of computing income applicable to common stock and

earnings per common share) during the years 20X1 through 20X3.

Accordingly, the staff believes that discounts on increasing rate preferred stock should be amortized over the period(s) preceding commencement of the perpetual dividend, by charging imputed dividend cost against retained earnings and increasing the carrying amount of the preferred stock by a corresponding amount. The discount at time of issuance should be computed as the present value of the difference between (a) dividends that will be payable, if any, in the period(s) preceding commencement of the perpetual dividend; and (b) the perpetual dividend amount for a corresponding number of periods; discounted at a market rate for dividend yield on preferred stocks that are comparable (other than with respect to dividend payment schedules) from an investment standpoint. The amortization in each period should be the amount which, together with any stated dividend for the period (ignoring fluctuations in stated dividend amounts that might result from variable rates,³ results in a constant rate of effective cost vis-a-vis the carrying amount of the preferred stock (the market rate that was used to compute the discount).

Simplified (ignoring quarterly calculations) application of this accounting to the Class A preferred stock described in the "Facts" section of this bulletin would produce the following results on a per share basis:

CARRYING AMOUNT OF PREFERRED STOCK

	Beginning of Year (BOY)	Imputed Dividend (8% of Carrying Amount at BOY)	End of year
Year 20X1	\$79.38	6.35	85.73
Year 20X2	85.73	6.86	92.59
Year 20X3	92.59	7.41	100.00

During 20X4 and thereafter, the stated dividend of \$8 measured against the carrying amount of \$100⁴ would reflect dividend cost of 8%, the market rate at time of issuance.

The staff believes that existing authoritative literature, while not explicitly addressing increasing rate

preferred stocks, implicitly calls for the accounting described in this bulletin.

The pervasive, fundamental principle of accrual accounting would, in the staff's view, preclude registrants from recognizing the dividend cost on the basis of whatever cash payment schedule might be arranged.

Furthermore, recognition of the effective cost of unstated rights and privileges is well-established in accounting, and is specifically called for by APB Opinion 21 and Topic 3.C of this codification for unstated interest costs of debt capital and unstated dividend costs of redeemable preferred stock capital,

¹ "Nonredeemable" preferred stock, as used in this SAB, refers to preferred stocks which are not redeemable or are redeemable only at the option of the issuer.

² As described in the "Facts" section of the issue, a registrant would receive less in proceeds for a preferred stock, if the stock were to pay less than its perpetual dividend for some initial period(s), than if it were to pay perpetual dividend from date of issuance. The staff views the discount on

increasing rate preferred stock as equivalent to a prepayment of dividends by the issuer, as though the issuer had concurrently (a) issued the stock with the perpetual dividend being payable from date of issuance, and (b) returned to the investor a portion of the proceeds representing the present value of certain future dividend entitlements which the investor agreed to forgo.

³ See Question 3 regarding variable increasing rate preferred stocks.

⁴ It should be noted that the \$100 per share amount used in this issue is for illustrative purposes, and is not intended to imply that application of this issue will necessarily result in the carrying amount of nonredeemable preferred stock being accreted to its par value, stated value, voluntary redemption value or involuntary liquidation value.

respectively. The staff believes that the requirement to recognize the effective periodic cost of capital applies also to nonredeemable preferred stocks because, for that purpose, the distinction between debt capital and preferred equity capital (whether redeemable⁵ or nonredeemable) is irrelevant from the standpoint of common stock interests.

Question 3: Would the accounting for discounts on increasing rate preferred stock be affected by variable stated dividend rates?

Interpretive Response: No. If stated dividends on an increasing rate preferred stock are variable, computations of initial discount and subsequent amortization should be based on the value of the applicable index at date of issuance and should not be affected by subsequent changes in the index.

For example, assume that a preferred stock issued 1/1/X1 is scheduled to pay dividends at annual rates, applied to the stock's par value, equal to 20% of the actual (fluctuating) market yield on a particular Treasury security in 20X1 and 20X2, and 90% of the fluctuating market yield in 20X3 and thereafter. The discount would be computed as the present value of a two-year dividend stream equal to 70% (90% less 20%) of the 1/1/X1 Treasury security yield, annually, on the stock's par value. The discount would be amortized in years 20X1 and 20X2 so that, together with 20% of the 1/1/X1 Treasury yield on the stock's par value, a constant rate of cost vis-a-vis the stock's carrying amount would result. Changes in the Treasury security yield during 20X1 and 20X2 would, of course, cause the rate of total reported preferred dividend cost (amortization of discount plus cash dividends) in those years to be more or less than the rate indicated by discount amortization plus 20% of the 1/1/X1 Treasury security yield. However, the fluctuations would be due solely to the impact of changes in the index on the stated dividends for those periods.

Question 4: Will the staff expect retroactive changes by registrants to comply with the accounting described in this bulletin?

Interpretive Response: All registrants will be expected to follow the accounting described in this bulletin for

increasing rate preferred stocks issued after December 4, 1986.⁶ Registrants that have not followed this accounting for increasing rate preferred stocks issued before that date were encouraged to retroactively change their accounting for those preferred stocks in the financial statements next filed with the Commission. The staff did not object if registrants did not make retroactive changes for those preferred stocks, provided that all presentations of and discussions regarding income applicable to common stock and earnings per share in future filings and shareholders' reports are accompanied by equally prominent supplemental disclosures (on the face of the income statement, in presentations of selected financial data, in MD&A, etc.) of the impact of not changing their accounting and an explanation of such impact (e.g., that dividend cost has been recognized on a cash basis).

R. Deleted by SAB 103

S. Quasi-Reorganization

Facts: As a consequence of significant operating losses and/or recent write-downs of property, plant and equipment, a company's financial statements reflect an accumulated deficit. The company desires to eliminate the deficit by reclassifying amounts from paid-in-capital. In addition, the company anticipates adopting a discretionary change in accounting principles¹ that will be recorded as a cumulative-effect type of accounting change. The recording of the cumulative effect will have the result of increasing the company's retained earnings.

Question 1: May the company reclassify its capital accounts to eliminate the accumulated deficit without satisfying all of the conditions enumerated in Section 210² of the Codification of Financial Reporting Policies for a quasi-reorganization?

Interpretive Response: No. The staff believes a deficit reclassification of any nature is considered to be a quasi-reorganization. As such, a company may not reclassify or eliminate a deficit in retained earnings unless all requisite

conditions set forth in Section 210³ for a quasi-reorganization are satisfied.⁴

Question 2: Must the company implement the discretionary change in accounting principle simultaneously with the quasi-reorganization or may it adopt the change after the quasi-reorganization has been effected?

Interpretive Response: The staff has taken the position that the company should adopt the anticipated accounting change prior to or as an integral part of the quasi-reorganization. Any such accounting change should be effected by following GAAP with respect to the change.⁵

Chapter 7A of ARB 43 indicates that, following a quasi-reorganization, a "company's accounting should be substantially similar to that appropriate for a new company." The staff believes that implicit in this "fresh-start" concept is the need for the company's accounting principles in place at the time of the quasi-reorganization to be those planned to be used following the reorganization to avoid a misstatement of earnings and retained earnings after the reorganization.⁶ Chapter 7A of ARB 43 states, in part, " * * * in general, assets should be carried forward as of the date of the readjustment at fair and

³ Section 210 (ASR 25) indicates the following conditions under which a quasi-reorganization can be effected without the creation of a new corporate entity and without the intervention of formal court proceedings:

1. Earned surplus, as of the date selected, is exhausted;
2. Upon consummation of the quasi-reorganization, no deficit exists in any surplus account;
3. The entire procedure is made known to all persons entitled to vote on matters of general corporate policy and the appropriate consents to the particular transactions are obtained in advance in accordance with the applicable laws and charter provisions;
4. The procedure accomplishes, with respect to the accounts, substantially what might be accomplished in a reorganization by legal proceedings—namely, the restatement of assets in terms of present considerations as well as appropriate modifications of capital and capital surplus, in order to obviate, so far as possible, the necessity of future reorganization of like nature.

⁴ In addition, ARB 43, Chapter 7A, outlines procedures that must be followed in connection with and after a quasi-reorganization.

⁵ Opinion 20 provides accounting principles to be followed when adopting accounting changes. In addition, many newly-issued accounting pronouncements provide specific guidance to be followed when adopting the accounting specified in such pronouncements.

⁶ Certain newly-issued accounting standards do not require adoption until some future date. The staff believes, however, that if the registrant intends or is required to adopt those standards within 12 months following the quasi-reorganization, the registrant should adopt those standards prior to or as an integral part of the quasi-reorganization. Further, registrants should consider early adoption of standards with effective dates more than 12 months subsequent to a quasi-reorganization.

⁵ Application of the interest method with respect to redeemable preferred stocks pursuant to Topic 3.C results in accounting consistent with the provisions of this bulletin irrespective of whether the redeemable preferred stocks have constant or increasing stated dividend rates. The interest method, as described in APB Opinion 21, produces a constant effective periodic rate of cost that is comprised of amortization of discount as well as the stated cost of each period.

⁶ The staff first publicly expressed its view as to the appropriate accounting at the December 3–4, 1986 meeting of the EITF.

¹ Discretionary accounting changes require the filing of a preferability letter by the registrant's independent accountant pursuant to Item 601 of Regulation S-K and Rule 10-01(b)(6) of Regulation S-X, respectively.

² ASR 25.

not unduly conservative amounts, **determined with due regard for the accounting to be employed by the Company thereafter.**" (emphasis added)

In addition, the staff believes that adopting a discretionary change in accounting principle that will be reflected in the financial statements within 12 months following the consummation of a quasi-reorganization leads to a presumption that the accounting change was contemplated at the time of the quasi-reorganization.⁷

Question 3: In connection with a quasi-reorganization, may there be a write-up of net assets?

Interpretive Response: No. The staff believes that increases in the recorded values of specific assets (or reductions in liabilities) to fair value are appropriate providing such adjustments are factually supportable, however, the amount of such increases are limited to offsetting adjustments to reflect decreases in other assets (or increases in liabilities) to reflect their new fair value. In other words, a quasi-reorganization should not result in a write-up of net assets of the registrant.

Question 4: The interpretive response to question 1 indicates that the staff believes that a deficit reclassification of any nature is considered to be a quasi-reorganization, and accordingly, must satisfy all the conditions of Section 210.⁸ Assume a company has satisfied all the requisite conditions of Section 210, and has eliminated a deficit in retained earnings by a concurrent reduction in paid-in capital, but did not need to restate assets and liabilities by a charge to capital because assets and liabilities were already stated at fair values. How should the company reflect the tax benefits of operating loss or tax credit carryforwards for financial reporting purposes that existed as of the date of the quasi-reorganization when such tax benefits are subsequently recognized for financial reporting purposes?

Interpretive Response: The staff believes Statement 109 requires that any subsequently recognized tax benefits of operating loss or tax credit carryforwards that existed as of the date of a quasi-reorganization be reported as a direct addition to paid-in capital. The staff believes that this position is consistent with the "new company" or "fresh-start" concept embodied in

Section 210,⁹ and in existing accounting literature regarding quasi-reorganizations, and with the FASB staff's justification for such a position when they stated that a "new enterprise would not have tax benefits attributable to operating losses or tax credits that arose prior to its organization date."¹⁰

The FASB recognized that a practice existed of recording deficit elimination type quasi-reorganizations without evaluating the concurrent need to restate assets and liabilities to fair values, and provided guidance on accounting for the tax benefits of carryforward items subsequent to such an event.¹¹ This practice and accounting is not permitted by Section 210, and accordingly, is not appropriate for registrants. The staff believes that all registrants that comply with the requirements of Section 210 in effecting a quasi-reorganization should apply the accounting required by the first sentence of paragraph 39 of Statement 109 for the tax benefits of tax

⁹ Section 210 (ASR 25) discusses the "conditions under which a quasi-reorganization has come to be applied in accounting to the corporate procedures in the course of which a company, without creation of new corporate entity and without intervention of formal court proceedings, is enabled to eliminate a deficit whether resulting from operations or recognition of other losses or both and to establish a new earned surplus account for the accumulation of earnings subsequent to the date selected as the effective date of the quasi-reorganization." It further indicates that "it is implicit in a procedure of this kind that it is not to be employed recurrently, **but only under circumstances which would justify an actual reorganization or formation of a new corporation**, particularly if the sole purpose of the quasi-reorganization is the elimination of a deficit in earned surplus resulting from operating losses." (emphasis added)

¹⁰ FASB Special Report: A Guide to Implementation of Statement 109 on Accounting for Income Taxes: Questions and Answers answer 9 states in part: "ARB 43, Chapter 7, 'Capital Accounts,' states that after a quasi-reorganization, the enterprise's accounting should be substantially similar to that appropriate for a new enterprise. As such, any subsequently recognized tax benefit of an operating loss or tax credit carryforward that existed at the date of a quasi-reorganization should not be included in the determination of income of the "new" enterprise, regardless of whether losses that gave rise to an operating loss carryforward were charged to income prior to the quasi-reorganization or directly to contributed capital as part of the quasi-reorganization. A new enterprise would not have tax benefits attributable to operating losses or tax credits that arose prior to its organization date."

¹¹ Statement 109, paragraph 39, states, in part: "The only exception is for enterprises that have previously both adopted Statement 96 and effected a quasi reorganization that involves only the elimination of a deficit in retained earnings by a concurrent reduction in contributed capital prior to adopting this Statement. For those enterprises, subsequent recognition of the tax benefit of prior deductible temporary differences and carryforwards is included in income and reported as required by paragraph 37 * * * and then reclassified from retained earnings to contributed capital." Also, see Footnote 10.

carryforward items.¹² Therefore, even though the only effect of a quasi-reorganization is the elimination of a deficit in retained earnings because assets and liabilities are already stated at fair values and the revaluation of assets and liabilities is unnecessary (or a write-up of net assets is prohibited as indicated in the interpretive response to question 3 above), subsequently recognized tax benefits of operating loss or tax credit carryforward items should be recorded as a direct addition to paid-in capital.

Question 5: If a company had previously recorded a quasi-reorganization that only resulted in the elimination of a deficit in retained earnings, may the company reverse such entry and "undo" its quasi-reorganization?

Interpretive Response: No. The staff believes Opinion 20 would preclude such a change in accounting. It states: "a method of accounting that was previously adopted for a type of transaction or event which is being terminated **or which was a single, nonrecurring event in the past should not be changed.**" (emphasis added)¹³

T. Accounting for Expenses or Liabilities Paid by Principal Stockholder(s)

Facts: Company X was a defendant in litigation for which the company had not recorded a liability in accordance with Statement 5. A principal stockholder of the company transfers a portion of his shares to the plaintiff to settle such litigation. If the company had settled the litigation directly, the company would have recorded the settlement as an expense.

Question: Must the settlement be reflected as an expense in the company's financial statements, and if so, how?

Interpretive Response: Yes. The value of the shares transferred should be reflected as an expense in the company's financial statements with a corresponding credit to contributed (paid-in) capital.

The staff believes that such a transaction is similar to those described in AICPA Interpretation 1 to Opinion 25 in which a principal stockholder¹

¹² The first sentence of paragraph 39 of Statement 109 states: "[t]he tax benefit of deductible temporary differences and carryforwards as of the date of a quasi reorganization as defined and contemplated in ARB 43, Chapter 7, ordinarily are reported as a direct addition to contributed capital if the tax benefits are recognized in subsequent years."

¹³ Opinion 20, paragraph 16.

¹ Statement 57, paragraph 24e, defines principal owners as "owners of record or known beneficial owners of more than 10 percent of the voting interests of the enterprise."

⁷ Certain accounting changes require restatement of prior financial statements. The staff believes that if a quasi-reorganization had been recorded in a restated period, the effects of the accounting change on quasi-reorganization adjustments should also be restated to properly reflect the quasi-reorganization in the restated financial statements.

⁸ See footnote 3.

establishes or finances a stock option, purchase or award plan for one or more employees of the company.

Interpretation 1 states that "if a principal stockholder's intention is to enhance or maintain the value of his investment by entering into such an arrangement, the corporation is implicitly benefiting from the plan by retention of, and possibly improved performance by, the employee. In this case, the benefits to a principal stockholder and to the corporation are generally impossible to separate. Similarly, it is virtually impossible to separate a principal stockholder's personal satisfaction from the benefit to the corporation." As a result, Interpretation 1 requires the company to account for such a transaction as if it were a compensatory plan adopted by the company, with an offsetting contribution to capital, unless: (1) The stockholder's relationship to the employee would normally result in generosity, (2) the stockholder has an obligation to the employee which is unrelated to employment, or (3) the company clearly does not benefit from the transaction.

The staff believes that the problem of separating the benefit to the principal stockholder from the benefit to the company cited in Interpretation 1 is not limited to transactions involving stock compensation. Therefore, similar accounting is required in this and other² transactions where a principal stockholder pays an expense for the company, unless the stockholder's action is caused by a relationship or obligation completely unrelated to his position as a stockholder or such action clearly does not benefit the company.

Some registrants and their accountants have taken the position that since Statement 57 applies to these transactions and requires only the disclosure of material related party transactions, the staff should not require the accounting called for by Interpretation 1 for transactions other than those specifically covered by it. The staff notes, however, that Statement 57 does not address the measurement of related party transactions and that, as a result, such transactions are generally recorded at the amounts indicated by their terms.³ However, the staff believes

that transactions of the type described above differ from the typical related party transactions.

The transactions for which Statement 57 requires disclosure generally are those in which a company receives goods or services directly from, or provides goods or services directly to, a related party, and the form and terms of such transactions may be structured to produce either a direct or indirect benefit to the related party. The participation of a related party in such a transaction negates the presumption that transactions reflected in the financial statements have been consummated at arm's length. Disclosure is therefore required to compensate for the fact that, due to the related party's involvement, the terms of the transaction may produce an accounting measurement for which a more faithful measurement may not be determinable.

However, transactions of the type discussed in the facts given do not have such problems of measurement and appear to be transacted to provide a benefit to the stockholder through the enhancement or maintenance of the value of the stockholder's investment. The staff believes that the substance of such transactions is the payment of an expense of the company through contributions by the stockholder. Therefore, the staff determined that it was inappropriate to permit accounting according to the form of the transaction.

U. Gain Recognition on the Sale of A Business or Operating Assets to A Highly Leveraged Entity

Facts: A registrant has sold a subsidiary, division or operating assets to a newly formed, thinly capitalized, highly leveraged entity (NEWCO) for cash or a combination of cash and securities, which may include subordinated debt, preferred stock, warrants, options or other instruments issued by NEWCO. In some of these transactions, registrants may guarantee debt or enter into other agreements (sometimes referred to as make-well agreements) that may require the registrant to infuse cash into NEWCO under certain circumstances. Securities received in the transaction are not actively traded and are subordinate to

statements or a pro forma presentation (depending on the circumstances), related party transactions at amounts other than those indicated by their terms. Two such circumstances are addressed in Staff Accounting Bulletin Topic 1.B.1, Questions 3 and 4. Another example is where the terms of a material contract with a related party are expected to change upon the completion of an offering (*i.e.*, the principal shareholder requires payment for services which had previously been contributed by the shareholder to the company)

substantially all of NEWCO's other debt. The value of the consideration received appears to exceed the cost basis of the net assets sold.

Question 1: Assuming the transaction may be properly accounted for as a divestiture,¹ does the staff believe it is appropriate for the registrant to recognize a gain?

Interpretive Response: The staff believes there often exist significant uncertainties about the seller's ability to realize non-cash proceeds received in transactions in which the purchaser is a thinly capitalized, highly leveraged entity, particularly when its assets consist principally of those purchased from the seller. The staff believes that such uncertainties raise doubt as to whether immediate gain recognition is appropriate. Factors that may lead the staff to question gain recognition in such transactions include:

1. Situations in which the assets or operations sold have historically not produced cash flows from operations² that will be sufficient to fund future debt service and full dividend requirements on a current basis.³ Often the servicing of debt and preferred dividend requirements is dependent upon future events that cannot be assured, such as sales of assets or improvements in earnings.

2. The lack of any substantial amount of equity capital in NEWCO other than that provided by the registrant; and/or

3. The existence of contingent liabilities of the registrant, such as debt guarantees or agreements that require

¹ Transactions such as these require careful evaluation to determine whether, in substance, a divestiture has occurred. SAB Topic 5.E provides the staff's views on circumstances that may exist that would lead the staff to conclude that the risks of the business have not been transferred to the new owners and that a divestiture has not occurred. Topic 5.E indicates that factors to consider in determining whether a transaction should be accounted for as a divestiture include:

- Continuing involvement by the seller in the business;
- Absence of a significant financial investment in the business by the buyer;
- Repayment of debt, which constitutes the principal consideration in the transaction, is dependent on future successful operations; or
- The continued necessity for debt or contract performance guarantees on behalf of the business by the seller.

Further, the seller should consider whether it is required to consolidate the entity by way of its variable interests held in the NEWCO pursuant to the provisions of FASB Interpretation 46.

² As defined in paragraphs 21–24 of Statement 95.

³ The ability of NEWCO to fund the debt service and the dividend requirement(s) should be evaluated on a full accrual basis—*i.e.*, irrespective of the purchaser's ability to satisfy those requirements through deferral (contractually or otherwise) of any required cash payments or the issuance of additional securities to satisfy such requirements.

² For example, SAB Topic 1.B indicates that the separate financial statements of a subsidiary should reflect any costs of its operations which are incurred by the parent on its behalf. Additionally, the staff notes that AICPA Technical Practice Aids § 4160 also indicates that the payment by principal stockholders of a company's debt should be accounted for as a capital contribution.

³ However, in some circumstances it is necessary to reflect, either in the historical financial

the registrant to infuse cash into NEWCO under certain circumstances.

The staff also believes that even where the registrant receives solely cash proceeds, the recognition of any gain would be impacted by the existence of any guarantees or other agreements that may require the registrant to infuse cash into NEWCO, particularly when the first two factors listed above exist.

Question 2: If immediate recognition of all or a portion of the apparent gain is not appropriate due to the existence of facts and circumstances similar to the above, at what future date should the gain be recognized and how should the deferred gain be disclosed in the financial statements?

Interpretive Response: Generally, the staff believes that the deferred gain⁴ should not be recognized until such time as cash flows from operating activities are sufficient to fund debt service and dividend requirements (on a full accrual basis)⁵ or the registrant's investment in NEWCO has been or could be readily converted to cash (e.g., active trading market develops in NEWCO securities and the registrant is not restricted from selling such securities, the registrant sells the securities received on a nonrecourse basis, etc.) and the registrant has no further obligations under any debt guarantees or other agreements that would require it to make additional investments in NEWCO.

The staff believes that the amount of any deferred gain (including deferral of interest or dividend income on securities received) should be disclosed on the face of the balance sheet as a deduction from the related asset account (i.e., investment in NEWCO). The footnotes to the financial statements should include a complete description of the transaction, including the existence of any commitments and contingencies, the terms of the securities received, and the accounting treatment of amounts due thereon.

V. Certain Transfers of Nonperforming Assets

Facts: A financial institution desires to reduce its nonaccrual or reduced rate loans and other nonearning assets, including foreclosed real estate (collectively, "nonperforming assets"). Some or all of such nonperforming assets are transferred to a newly-formed

entity (the "new entity"). The financial institution, as consideration for transferring the nonperforming assets, may receive (a) the cash proceeds of debt issued by the new entity to third parties, (b) a note or other redeemable instrument issued by the new entity, or (c) a combination of (a) and (b). The residual equity interests in the new entity, which carry voting rights, initially owned by the financial institution, are transferred to outsiders (for example, via distribution to the financial institution's shareholders or sale or contribution to an unrelated third party).

The financial institution typically will manage the assets for a fee, providing necessary services to liquidate the assets, but otherwise does not have the right to appoint directors or legally control the operations of the new entity.

Statement 140 provides guidance for determining when a transfer of financial assets can be recognized as a sale. The interpretive guidance provided in response to Questions 1 and 2 of this SAB does not apply to transfers of financial assets falling within the scope of Statement 140. Because Statement 140 does not apply to distributions of financial assets to shareholders or a contribution of such assets to unrelated third parties, the interpretive guidance provided in response to Questions 1 and 2 of this SAB would apply to such conveyances.

Further, registrants should consider the guidance contained in FASB Interpretation 46 in determining whether it should consolidate the newly-formed entity.

Question 1: What factors should be considered in determining whether such transfer of nonperforming assets can be accounted for as a disposition by the financial institution?

Interpretive Response: The staff believes that determining whether nonperforming assets have been disposed of in substance requires an assessment as to whether the risks and rewards of ownership have been transferred. SAB Topic 5.E¹ discusses some factors that the staff believes should be considered in determining whether the risks of a business have been transferred. Consistent with the factors discussed in SAB Topic 5.E, the staff believes that the transfer described should not be accounted for as a sale or disposition if (a) the transfer of nonperforming assets to the new entity provides for recourse by the new entity

to the transferor financial institution, (b) the financial institution directly or indirectly guarantees debt of the new entity in whole or in part, (c) the financial institution retains a participation in the rewards of ownership of the transferred assets, for example through a higher than normal incentive or other management fee arrangement,² or (d) the fair value of any material non-cash consideration received by the financial institution (for example, a note or other redeemable instrument) cannot be reasonably estimated. Additionally, the staff believes that the accounting for the transfer as a sale or disposition generally is not appropriate where the financial institution retains rewards of ownership through the holding of significant residual equity interests or where third party holders of such interests do not have a significant amount of capital at risk.

Where accounting for the transfer as a sale or disposition is not appropriate, the nonperforming assets should remain on the financial institution's balance sheet and should continue to be disclosed as nonaccrual, past due, restructured or foreclosed, as appropriate, and the debt of the new entity should be recorded by the financial institution.

Question 2: If the transaction is accounted for as a sale to an unconsolidated party, at what value should the transfer be recorded by the financial institution?

Interpretive Response: The staff believes that the transfer should be recorded by the financial institution at the fair value of assets transferred (or, if more clearly evident, the fair value of assets received) and a loss recognized by the financial institution for any excess of the net carrying value³ over the fair value.⁴ Fair value is the amount that

² The staff recognizes that the determination of whether the financial institution retains a participation in the rewards of ownership will require an analysis of the facts and circumstances of each individual transaction. Generally, the staff believes that, in order to conclude that the financial institution has disposed of the assets in substance, the management fee arrangement should not enable the financial institution to participate to any significant extent in the potential increases in cash flows or value of the assets, and the terms of the arrangement, including provisions for discontinuance of services, must be substantially similar to management arrangements with third parties.

³ The carrying value should be reduced by any allocable allowance for credit losses or other valuation allowances. The staff believes that the loss recognized for the excess of the net carrying value over the fair value should be considered a credit loss and this should not be included by the financial institution as loss on disposition.

⁴ The staff notes that the EITF reached a consensus at its November 17, 1988 meeting on

⁴ In situations in which the gain is deferred following the guidance in this SAB, the staff believes that the seller generally should not recognize any income from the securities received in such transactions (including accretion of securities to their face or redemption value) until realization is more fully assured.

⁵ See note 4.

¹ SAB Topic 5.E addresses the accounting for the transfer of certain operations whereby there is a continuing involvement by the seller or other evidence that incidents of ownership remain with the seller.

would be realizable in an outright sale to an unrelated third party for cash.⁵ The same concepts should be applied in determining fair value of the transferred assets, *i.e.*, if an active market exists for the assets transferred, then fair value is equal to the market value. If no active market exists, but one exists for similar assets, the selling prices in that market may be helpful in estimating the fair value. If no such market price is available, a forecast of expected cash flows, discounted at a rate commensurate with the risks involved, may be used to aid in estimating the fair value. In situations where discounted cash flows are used to estimate fair value of nonperforming assets, the staff would expect that the interest rate used in such computations will be substantially higher than the cost of funds of the financial institution and appropriately reflect the risk of holding these nonperforming assets. Therefore, the fair value determined in such a way will be lower than the amount at which the assets would have been carried by the financial institution had the transfer not occurred, unless the financial institution had been required under GAAP to carry such assets at market value or the lower of cost or market value.

Question 3: Where the transaction may appropriately be accounted for as a sale to an unconsolidated party and the financial institution receives a note receivable or other redeemable instrument from the new entity, how should such asset be disclosed pursuant to Item III C, "Risk Elements," of Industry Guide 3? What factors should be considered related to the subsequent accounting for such instruments received?

Interpretive Response: The staff believes that the financial institution may exclude the note receivable or other asset from its Risk Elements disclosures under Guide 3 provided that: (a) the receivable itself does not constitute a nonaccrual, past due, restructured, or potential problem loan that would require disclosure under Guide 3, and (b) the underlying collateral is described in sufficient detail to enable investors to understand the nature of the note receivable or other asset, if material, including the extent of any over-collateralization. The description of the collateral normally would include

material information similar to that which would be provided if such assets were owned by the financial institution, including pertinent Risk Element disclosures.

The staff notes that, in situations in which the transaction is accounted for as a sale to an unconsolidated party and a portion of the consideration received by the registrant is debt or another redeemable instrument, careful consideration must be given to the appropriateness of recording profits on the management fee arrangements or interest or dividends on the instrument received, including consideration of whether it is necessary to defer such amounts or to treat such payments on a cost recovery basis. Further, if the new entity incurs losses to the point that its permanent equity based on GAAP is eliminated, it would ordinarily be necessary for the financial institution, at a minimum, to record further operating losses as its best estimate of the loss in realizable value of its investment.⁶

W. Contingency Disclosures Regarding Property-Casualty Insurance Reserves for Unpaid Claim Costs

Facts: A property-casualty insurance company (the "Company") has established reserves in accordance with Statement 60 for unpaid claim costs, including estimates of costs relating to claims incurred but not reported ("IBNR").¹ The reserve estimate for IBNR claims was based on past loss experience and current trends except that the estimate has been adjusted for recent significant unfavorable claims experience that the Company considers to be nonrecurring and abnormal. The Company attributes the abnormal claims experience to a recent acquisition and accelerated claims processing; however, actuarial studies have been inconclusive and subject to varying interpretations. Although the reserve is deemed adequate to cover all probable claims, there is a reasonable possibility that the abnormal claims experience could continue, resulting in a material understatement of claim reserves.

Statement 5 requires, among other things, disclosure of loss contingencies.²

⁶ Typically, the financial institution's claim on the new entity is subordinate to other debt instruments and thus the financial institution will incur any losses beyond those incurred by the permanent equity holders.

¹ Paragraph 18 of Statement 60 prescribes that "[t]he liability for unpaid claims shall be based on the estimated ultimate cost of settling the claims (including the effects of inflation and other societal and economic factors), using past experience adjusted for current trends, and any other factors that would modify past experience." [Footnote reference omitted]

² Paragraph 10 of Statement 5 specified that "[i]f no accrual is made for a loss contingency because

However, paragraph 2 of that Statement notes that "[n]ot all uncertainties inherent in the accounting process give rise to contingencies as that term is used in [Statement 5]."

SOP 94-6³ also provides disclosure guidance regarding certain significant estimates.

Question 1: In the staff's view, do Statement 5 and SOP 94-6 disclosure requirements apply to property-casualty insurance reserves for unpaid claim costs? If so, how?

Interpretive Response: Yes. The staff believes that specific uncertainties (conditions, situations and/or sets of circumstances) not considered to be normal and recurring because of their significance and/or nature can result in loss contingencies⁴ for purposes of applying Statement 5 and SOP 94-6 disclosure requirements. General uncertainties, such as the amount and timing of claims, that are normal, recurring, and inherent to estimations of property-casualty insurance reserves are not considered subject to the disclosure requirements of Statements 5. Some specific uncertainties that may result in loss contingencies pursuant to Statement 5, depending on significance and/or nature, include insufficiently understood trends in claims activity; judgmental adjustments to historical experience for purposes of estimating future claim costs (other than for normal recurring general uncertainties); significant risks to an individual claim or group of related claims; or catastrophe losses. The requirements of SOP 94-6 apply when "[i]t is at least reasonably possible that the estimate of

one or both of the conditions in paragraph 8 are not met, or if an exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 8, disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred. The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss, or state that such an estimate cannot be made." [Footnote reference omitted and emphasis added.]

³ SOP 94-6 provides that disclosures regarding certain significant estimates should be made when the following criteria are met. The SOP provides that:

The disclosure should indicate the nature of the uncertainty and include an indication that it is at least reasonably possible that a change in the estimate will occur in the near term. If the estimate involves a loss contingency covered by [Statement] 5, the disclosure also should include an estimate of the possible loss or range of loss, or state that such an estimate cannot be made. Disclosure of the factors that cause the estimate to be sensitive to change is encouraged but not required. (footnote references omitted)

SOP 94-6 requires disclosures regarding current vulnerability due to certain concentrations which may be applicable as well.

⁴ The loss contingency referred to in this document is the potential for a material understatement of reserves for unpaid claims.

Issue 88-25 that the newly created "liquidating bank" should continue to report its assets and liabilities at fair values at the date of the financial statements.

⁵ The EITF reached a consensus on issue 11 of Issue 01-02 that an enterprise that distributes loans to its owners should report such distribution at fair value.

the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events * * * [and] the effect of the change would be material to the financial statements. ”

Question 2: Do the facts presented above describe an uncertainty that requires disclosures under Statement 5 and SOP 94–6?

Interpretive Response: Yes. The staff believes the judgmental adjustments to historical experience for insufficiently understood claims activity noted above results in a loss contingency within the scope of Statement 5 and SOP 94–6. Based on the facts presented above, at a minimum the Company’s financial statements should disclose that for purposes of estimating IBNR claim reserves, past experience was adjusted for what management believes to be abnormal claims experience related to the recent acquisition of Company A and accelerated claims processing. It should also be disclosed that there is a reasonable possibility that the claims experience could be the indication of an unfavorable trend which would require additional IBNR claim reserves in the approximate range of \$XX–\$XX million (alternatively, if Company management is unable to estimate the possible loss or range of loss, a statement to that effect should be disclosed).

Additionally, the staff also expects companies to disclose the nature of the loss contingency and the potential impact on trends in their loss reserve development discussions provided pursuant to Property-Casualty Industry Guides 4 and 6. Consideration should also be given to the need to provide disclosure in MD&A.

Question 3: Does the staff have an example in which specific uncertainties involving an individual claim or group of related claims result in a loss contingency the staff believes requires disclosure?

Interpretive Response: Yes. A property-casualty insurance company (the “Company”) underwrites product liability insurance for an insured manufacturer which has produced and sold millions of units of a particular product which has been used effectively and without problems for many years. Users of the product have recently begun to report serious health problems that they attribute to long term use of the product and have asserted claims under the insurance policy underwritten and retained by the Company. To date, the number of users reporting such problems is relatively small, and there is presently no

conclusive evidence that demonstrates a causal link between long term use of the product and the health problems experienced by the claimants. However, the evidence generated to date indicates that there is at least a reasonable possibility that the product is responsible for the problems and the assertion of additional claims is considered probable, and therefore the potential exposure of the Company is material. While an accrual may not be warranted since the loss exposure may not be both probable and estimable, in view of the reasonable possibility of material future claim payments, the staff believes that disclosures made in accordance with Statement 5 and SOP 94–6 would be required under these circumstances.

The disclosure concepts expressed in this example would also apply to an individual claim or group of claims that are related to a single catastrophic event or multiple events having a similar effect.

X. Deleted by SAB 103

Y. Accounting and Disclosures Relating to Loss Contingencies

Facts: A registrant believes it may be obligated to pay material amounts as a result of product or environmental remediation liability. These amounts may relate to, for example, damages attributed to the registrant’s products or processes, clean-up of hazardous wastes, reclamation costs, fines, and litigation costs. The registrant may seek to recover a portion or all of these amounts by filing a claim against an insurance carrier or other third parties.

Question 1: Assuming that the registrant’s estimate of an environmental remediation or product liability meets the conditions set forth in paragraph 132 of SOP 96–1 for recognition on a discounted basis, what discount rate should be applied and what, if any, special disclosures are required in the notes to the financial statements?

Interpretive Response: The rate used to discount the cash payments should be the rate that will produce an amount at which the environmental or product liability could be settled in an arm’s-length transaction with a third party. SOP 96–1 further states that the discount rate used to discount the cash payments should not exceed the interest rate on monetary assets that are essentially risk free¹ and have maturities comparable to that of the environmental or product liability.

If the liability is recognized on a discounted basis to reflect the time

value of money, the notes to the financial statements should, at a minimum, include disclosures of the discount rate used, the expected aggregate undiscounted amount, expected payments for each of the five succeeding years and the aggregate amount thereafter, and a reconciliation of the expected aggregate undiscounted amount to amounts recognized in the statements of financial position. Material changes in the expected aggregate amount since the prior balance sheet date, other than those resulting from pay-down of the obligation, should be explained.

Question 2: What financial statement disclosures should be furnished with respect to recorded and unrecorded product or environmental remediation liabilities?

Interpretive Response: Paragraphs 9 and 10 of Statement 5 identify disclosures regarding loss contingencies that generally are furnished in notes to financial statements. SOP 96–1 identifies disclosures that are required and recommended regarding both recorded and unrecorded environmental remediation liabilities. The staff believes that product and environmental remediation liabilities typically are of such significance that detailed disclosures regarding the judgments and assumptions underlying the recognition and measurement of the liabilities are necessary to prevent the financial statements from being misleading and to inform readers fully regarding the range of reasonably possible outcomes that could have a material effect on the registrant’s financial condition, results of operations, or liquidity. In addition to the disclosures required by Statement 5 and SOP 96–1, examples of disclosures that may be necessary include:

- Circumstances affecting the reliability and precision of loss estimates.
- The extent to which unasserted claims are reflected in any accrual or may affect the magnitude of the contingency.
- Uncertainties with respect to joint and several liability that may affect the magnitude of the contingency, including disclosure of the aggregate expected cost to remediate particular sites that are individually material if the likelihood of contribution by the other significant parties has not been established.
- Disclosure of the nature and terms of cost-sharing arrangements with other potentially responsible parties.
- The extent to which disclosed but unrecognized contingent losses are expected to be recoverable through insurance, indemnification arrangements, or other sources, with

¹ As described in Concepts Statement 7.

disclosure of any material limitations of that recovery.

- Uncertainties regarding the legal sufficiency of insurance claims or solvency of insurance carriers.²
- The time frame over which the accrued or presently unrecognized amounts may be paid out.
- Material components of the accruals and significant assumptions underlying estimates.

Registrants are cautioned that a statement that the contingency is not expected to be material does not satisfy the requirements of Statement 5 if there is at least a reasonable possibility that a loss exceeding amounts already recognized may have been incurred and the amount of that additional loss would be material to a decision to buy or sell the registrant's securities. In that case, the registrant must either (a) disclose the estimated additional loss, or range of loss, that is reasonably possible, or (b) state that such an estimate cannot be made.

Question 3: What disclosures regarding loss contingencies may be necessary outside the financial statements?

Interpretive Response: Registrants should consider the requirements of Items 101 (Description of Business), 103 (Legal Proceedings), and 303 (MD&A) of Regulations S-K and S-B. The Commission has issued interpretive releases that provide additional guidance with respect to these items.³ In a 1989 interpretive release, the Commission noted that the availability of insurance, indemnification, or contribution may be relevant in determining whether the criteria for disclosure have been met with respect to a contingency.⁴ The registrant's assessment in this regard should include consideration of facts such as the periods in which claims for recovery may be realized, the likelihood that the claims may be contested, and the financial condition of third parties from which recovery is expected.

Disclosures made pursuant to the guidance identified in the preceding paragraph should be sufficiently

specific to enable a reader to understand the scope of the contingencies affecting the registrant. For example, a registrant's discussion of historical and anticipated environmental expenditures should, to the extent material, describe separately (a) recurring costs associated with managing hazardous substances and pollution in on-going operations, (b) capital expenditures to limit or monitor hazardous substances or pollutants, (c) mandated expenditures to remediate previously contaminated sites, and (d) other infrequent or non-recurring clean-up expenditures that can be anticipated but which are not required in the present circumstances. Disaggregated disclosure that describes accrued and reasonably likely losses with respect to particular environmental sites that are individually material may be necessary for a full understanding of these contingencies. Also, if management's investigation of potential liability and remediation cost is at different stages with respect to individual sites, the consequences of this with respect to amounts accrued and disclosed should be discussed.

Examples of specific disclosures typically relevant to an understanding of historical and anticipated product liability costs include the nature of personal injury or property damages alleged by claimants, aggregate settlement costs by type of claim, and related costs of administering and litigating claims. Disaggregated disclosure that describes accrued and reasonably likely losses with respect to particular claims may be necessary if they are individually material. If the contingency involves a large number of relatively small individual claims of a similar type, such as personal injury from exposure to asbestos, disclosure of the number of claims pending at each balance sheet date, the number of claims filed for each period presented, the number of claims dismissed, settled, or otherwise resolved for each period, and the average settlement amount per claim may be necessary. Disclosures should address historical and expected trends in these amounts and their reasonably likely effects on operating results and liquidity.

Question 4: What disclosures should be furnished with respect to site restoration costs or other environmental remediation costs?⁵

Interpretive Response: The staff believes that material liabilities for site restoration, post-closure, and monitoring commitments, or other exit

costs that may occur on the sale, disposal, or abandonment of a property as a result of unanticipated contamination of the asset should be disclosed in the notes to the financial statements. Appropriate disclosures generally would include the nature of the costs involved, the total anticipated cost, the total costs accrued to date, the balance sheet classification of accrued amounts, and the range or amount of reasonably possible additional losses. If an asset held for sale or development will require remediation to be performed by the registrant prior to development, sale, or as a condition of sale, a note to the financial statements should describe how the necessary expenditures are considered in the assessment of the asset's value and the possible need to reflect an impairment loss. Additionally, if the registrant may be liable for remediation of environmental damage relating to assets or businesses previously disposed, disclosure should be made in the financial statements unless the likelihood of a material unfavorable outcome of that contingency is remote.⁶ The registrant's accounting policy with respect to such costs should be disclosed in accordance with Opinion 22.

Z. Accounting and Disclosure Regarding Discontinued Operations

1. Deleted by SAB 103
2. Deleted by SAB 103
3. Deleted by SAB 103
4. Disposal of Operation With Significant Interest Retained

Facts: A Company disposes of its controlling interest in a component of an entity as defined by Statement 144. The Company retains a minority voting interest directly in the component or it holds a minority voting interest in the buyer of the component. Controlling interest includes those controlling interests established through other means, such as variable interests. Because the Company's voting interest enables it to exert significant influence over the operating and financial policies of the investee, the Company is required by Opinion 18 to account for its residual investment using the equity method.¹

Question: May the historical operating results of the component and the gain or

² The staff believes there is a rebuttable presumption that no asset should be recognized for a claim for recovery from a party that is asserting that it is not liable to indemnify the registrant. Registrants that overcome that presumption should disclose the amount of recorded recoveries that are being contested and discuss the reasons for concluding that the amounts are probable of recovery.

³ See Securities Act Release No. 6130, FR 36, Securities Act Release No. 33-8040, Securities Act Release No. 33-8039, and Securities Act Release 33-8176.

⁴ See, for example, footnote 30 of FR 36 (footnote 17 of Section 501.02 of the Codification of Financial Reporting Policies).

⁵ Registrants are reminded that Statement 143 provides guidance for accounting and reporting for costs associated with asset retirement obligations.

⁶ If the company has a guarantee as defined by Interpretation 45, the entity is required to provide the disclosures and recognize the fair value of the guarantee in the company's financial statements even if the "contingent" aspect of the guarantee is deemed to be remote.

¹ In some circumstances, the seller's continuing interest may be so great that divestiture accounting is inappropriate. See SAB Topic 5.E.

loss on the sale of the majority interest in the component be classified in the Company's statement of operations as "discontinued operations" pursuant to Statement 144?

Interpretive Response: No. A condition necessary for discontinued operations reporting, as indicated in paragraph 42 of Statement 144 is that an entity "not have any significant continuing involvement in the operations of the component after the disposal transaction." In these circumstances, the transaction should be accounted for as the disposal of a group of assets that is not a component of an entity and classified within continuing operations pursuant to Statement 144.²

5. Classification and Disclosure of Contingencies Relating to Discontinued Operations

Facts: A company disposed of a component of an entity in a previous accounting period. The Company received debt and/or equity securities of the buyer of the component or of the disposed component as consideration in the sale, but this financial interest is not sufficient to enable the Company to apply the equity method with respect to its investment in the buyer. The Company made certain warranties to the buyer with respect to the discontinued business, or remains liable under environmental or other laws with respect to certain facilities or operations transferred to the buyer. The disposition satisfied the criteria of Statement 144 for presentation as "discontinued operations." The Company estimated the fair value of the securities received in the transaction for purposes of calculating the gain or loss on disposal that was recognized in its financial statements. The results of discontinued operations prior to the date of disposal or classification as held for sale included provisions for the Company's existing obligations under environmental laws, product warranties, or other contingencies. The calculation of gain or loss on disposal included estimates of the Company's obligations arising as a direct result of its decision to dispose of the component, under its warranties to the buyer, and under environmental or other laws. In a period subsequent to the disposal date, the Company records a charge to income with respect to the securities because

their fair value declined materially and the Company determined that the decline was other than temporary. The Company also records adjustments of its previously estimated liabilities arising under the warranties and under environmental or other laws.

Question 1: Should the writedown of the carrying value of the securities and the adjustments of the contingent liabilities be classified in the current period's statement of operations within continuing operations or as an element of discontinued operations?

Interpretive Response: Adjustments of estimates of contingent liabilities or contingent assets that remain after disposal of a component of an entity or that arose pursuant to the terms of the disposal generally should be classified within discontinued operations.¹ However, the staff believes that changes in the carrying value of assets received as consideration in the disposal or of residual interests in the business should be classified within continuing operations.

Paragraph 44 of Statement 144 requires that "adjustments to amounts previously reported in discontinued operations that are directly related to the disposal of a component of an entity in a prior period shall be classified separately in the current period in discontinued operations." The staff believes that the provisions of paragraph 44 apply only to adjustments that are necessary to reflect new information about events that have occurred that becomes available prior to disposal of the component of the entity, to reflect the actual timing and terms of the disposal when it is consummated, and to reflect the resolution of contingencies associated with that component, such as warranties and environmental liabilities retained by the seller.

Developments subsequent to the disposal date that are not directly related to the disposal of the component or the operations of the component prior to disposal are not "directly related to the disposal" as contemplated by paragraph 44 of Statement 144. Subsequent changes in the carrying value of assets received upon disposition of a component do not affect the determination of gain or loss at the disposal date, but represent the consequences of management's subsequent decisions to hold or sell those assets. Gains and losses, dividend and interest income, and portfolio management expenses associated with

assets received as consideration for discontinued operations should be reported within continuing operations.

Question 2: What disclosures would the staff expect regarding discontinued operations prior to the disposal date and with respect to risks retained subsequent to the disposal date?

Interpretive Response: MD&A¹² should include disclosure of known trends, events, and uncertainties involving discontinued operations that may materially affect the Company's liquidity, financial condition, and results of operations (including net income) between the date when a component of an entity is classified as discontinued and the date when the risks of those operations will be transferred or otherwise terminated. Disclosure should include discussion of the impact on the Company's liquidity, financial condition, and results of operations of changes in the plan of disposal or changes in circumstances related to the plan. Material contingent liabilities,³ such as product or environmental liabilities or litigation, that may remain with the Company notwithstanding disposal of the underlying business should be identified in notes to the financial statements and any reasonably likely range of possible loss should be disclosed pursuant to Statement 5. MD&A should include discussion of the reasonably likely effects of these contingencies on reported results and liquidity. If the Company retains a financial interest in the discontinued component or in the buyer of that component that is material to the Company, MD&A should include discussion of known trends, events, and uncertainties, such as the financial condition and operating results of the issuer of the security, that may be reasonably expected to affect the amounts ultimately realized on the investments.

6. Deleted by SAB 103

7. Accounting for the Spin-off of a Subsidiary

Facts: A Company disposes of a business through the distribution of a subsidiary's stock to the Company's shareholders on a pro rata basis in a transaction that is referred to as a spin-off.

Question: May the Company elect to characterize the spin-off transaction as resulting in a change in the reporting entity and restate its historical financial statements as if the Company never had

² However, a plan of disposal that contemplates the transfer of assets to a limited-life entity created for the single purpose of liquidating the assets of a component of an entity would not necessitate classification within continuing operations solely because the registrant retains control or significant influence over the liquidating entity.

¹ Registrants are reminded that Interpretation 45 requires recognition and disclosure of certain guarantees which may impose accounting and disclosure requirements in addition to those discussed in this SAB Topic.

¹² Item 303 of Regulation S-K.

³ Registrants also should consider the disclosure requirements of Interpretation 45.

an investment in the subsidiary, in the manner specified by paragraph 34 of APB Opinion 20?

Interpretive Response: Not ordinarily. If the Company was required to file periodic reports under the Exchange Act within one year prior to the spin-off, the staff believes the Company should reflect the disposition in conformity with Statement 144. This presentation most fairly and completely depicts for investors the effects of the previous and current organization of the Company. However, in limited circumstances involving the initial registration of a company under the Exchange Act or Securities Act, the staff has not objected to financial statements that retroactively reflect the reorganization of the business as a change in the reporting entity if the spin-off transaction occurs prior to effectiveness of the registration statement. This presentation may be acceptable in an initial registration if the Company and the subsidiary are in dissimilar businesses, have been managed and financed historically as if they were autonomous, have no more than incidental common facilities and costs, will be operated and financed autonomously after the spin-off, and will not have material financial commitments, guarantees, or contingent liabilities to each other after the spin-off. This exception to the prohibition against retroactive omission of the subsidiary is intended for companies that have not distributed widely financial statements that include the spun-off subsidiary. Also, dissimilarity contemplates substantially greater differences in the nature of the businesses than those that would ordinarily distinguish reportable segments as defined by Statement 131.

AA. Deleted by SAB 103

BB. Inventory Valuation Allowances

Facts: ARB 43, Chapter 4, Statement 5, specifies that: “[a] departure from the cost basis of pricing the inventory is required when the utility of the goods is no longer as great as its cost. Where there is evidence that the utility of goods, in their disposal in the ordinary course of business, will be less than cost, whether due to physical obsolescence, changes in price levels, or other causes, the difference should be recognized as a loss of the current period. This is generally accomplished by stating such goods at a lower level commonly designated as market.”

Footnote 2 to that same chapter indicates that “[i]n the case of goods which have been written down below cost at the close of a fiscal period, such reduced amount is to be considered the

cost for subsequent accounting purposes.”

Lastly, Opinion 20 provides “inventory obsolescence” as one of the items subject to estimation and changes in estimates under the guidance in paragraphs 10–11 and 31–33 of that Opinion.

Question: Does the write-down of inventory to the lower of cost or market, as required by ARB 43, create a new cost basis for the inventory or may a subsequent change in facts and circumstances allow for restoration of inventory value, not to exceed original historical cost?

Interpretive Response: Based on ARB 43, footnote 2, the staff believes that a write-down of inventory to the lower of cost or market at the close of a fiscal period creates a new cost basis that subsequently cannot be marked up based on changes in underlying facts and circumstances.¹

CC. Impairments

Standards for recognizing and measuring impairment of the carrying amount of long-lived assets including certain identifiable intangibles to be held and used in operations are found in Statement 144. Standards for recognizing and measuring impairment of the carrying amount of goodwill and identifiable intangible assets that are not currently being amortized are found in Statement 142.

Facts: Company X has mainframe computers that are to be abandoned in six to nine months as replacement computers are put in place. The mainframe computers were placed in service in January 20X0 and were being depreciated on a straight-line basis over seven years. No salvage value had been projected at the end of seven years and the original cost of the computers was \$8,400. The board of directors, with the appropriate authority, approved the abandonment of the computers in March 20X3 when the computers had a remaining carrying value of \$4,600. No proceeds are expected upon abandonment. Abandonment cannot occur prior to the receipt and installation of replacement computers, which is expected prior to the end of 20X3. Management had begun reevaluating its mainframe computer capabilities in January 20X2 and had included in its 20X3 capital expenditures budget an estimated amount for new mainframe computers. The 20X3 capital expenditures budget had been prepared by management in August 20X2, had been discussed with

the company’s board of directors in September 20X2 and was formally approved by the board of directors in March 20X3. Management had also begun soliciting bids for new mainframe computers beginning in the fall of 20X2. The mainframe computers, when grouped with assets at the lowest level of identifiable cash flows, were not impaired on a “held and used” basis throughout this time period. Management had not adjusted the original estimated useful life of the computers (seven years) since 20X0.

Question 1: Company X proposes to recognize an impairment charge under Statement 144 for the carrying value of the mainframe computers of \$4,600 in March 20X3. Does Company X meet the requirements in Statement 144 to classify the mainframe computer assets as “to be abandoned?”

Interpretive Response: No. Statement 144, paragraph 28, provides that “a long-lived asset to be abandoned is disposed of when it ceases to be used. If an entity commits to a plan to abandon a long-lived asset before the end of its previously estimated useful life, depreciation estimates shall be revised in accordance with Opinion 20 to reflect the use of the asset over its shortened useful life.”

Question 2: Would the staff accept an adjustment to write down the carrying value of the computers to reflect a “normalized depreciation” rate for the period from March 20X3 through actual abandonment (e.g., December 20X3)? Normalized depreciation would represent the amount of depreciation otherwise expected to be recognized during that period without adjustment of the asset’s useful life, or \$1,000 (\$100/month for ten months) in the example fact pattern.

Interpretive Response: No. The mainframe computers would be viewed as “held and used” at March 20X3 under the fact pattern described. There is no basis under Statement 144 to write down an asset to an amount that would subsequently result in a “normalized depreciation” charge through the disposal date, whether disposal is to be by sale, abandonment, or other means. For an asset that meets the requirements to be classified as “held for sale” under Statement 144, paragraph 34 of that standard requires the asset to be valued at the lower of carrying amount or fair value less cost to sell. For assets that are classified as “held and used” under Statement 144, an assessment must first be made as to whether the asset (asset group) is impaired. Paragraph 7 of Statement 144 indicates that an impairment loss shall be recognized only if the carrying amount of a long-

¹ See also disclosure requirement for inventory balances in Rule 5–02(6) of Regulation S–X.

lived asset (asset group) is not recoverable and exceeds its fair value. The carrying amount of a long-lived asset (asset group) is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset (asset group). The staff would object to a write down of long-lived assets to a "normalized depreciation" value as representing an acceptable alternative to the approaches required in Statement 144.

The staff also believes that registrants must continually evaluate the appropriateness of useful lives assigned to long-lived assets, including identifiable intangible assets and goodwill. In the above fact pattern, management had contemplated removal of the mainframe computers beginning in January 20X2 and, more formally, in August 20X2 as part of compiling the 20X3 capital expenditures budget. At those times, at a minimum, management should have reevaluated the original useful life assigned to the computers to determine whether a seven year amortization period remained appropriate given the company's current facts and circumstances, including ongoing technological changes in the market place. This reevaluation process should have continued at the time of the September 20X2 board of directors' meeting to discuss capital expenditure plans and, further, as the company pursued mainframe computer bids. Given the contemporaneous evidence that management's best estimate during much of 20X2 was that the current mainframe computers would be removed from service in 20X3, the depreciable life of the computers should have been adjusted prior to 20X3 to reflect this new estimate. The staff does not view the recognition of an impairment charge to be an acceptable substitute for choosing the appropriate initial amortization or depreciation period or subsequently adjusting this period as company or industry conditions change. The staff's view applies also to selection of, and changes to, estimated residual values.

Consequently, the staff may challenge impairment charges for which the timely evaluation of useful life and residual value cannot be demonstrated.

Question 3: Has the staff expressed any views with respect to company-determined estimates of cash flows used for assessing and measuring impairment of assets under Statement 144?

Interpretive Response: In providing guidance on the development of cash flows for purposes of applying the provisions of Statement 144, paragraph 17 of that Statement indicates that

"estimates of future cash flows used to test the recoverability of a long-lived asset (asset group) shall incorporate the entity's own assumptions about its use of the asset (asset group) and shall consider all available evidence. The assumptions used in developing those estimates shall be reasonable in relation to the assumptions used in developing other information used by the entity for comparable periods, such as internal budgets and projections, accruals related to incentive compensation plans, or information communicated to others."

The staff recognizes that various factors, including management's judgments and assumptions about the business plans and strategies, affect the development of future cash flow projections for purposes of applying Statement 144. The staff, however, cautions registrants that the judgments and assumptions made for purposes of applying Statement 144 must be consistent with other financial statement calculations and disclosures and disclosures in MD&A. The staff also expects that forecasts made for purposes of applying Statement 144 be consistent with other forward-looking information prepared by the company, such as that used for internal budgets, incentive compensation plans, discussions with lenders or third parties, and/or reporting to management or the board of directors.

For example, the staff has reviewed a fact pattern where a registrant developed cash flow projections for purposes of applying the provisions of Statement 144 using one set of assumptions and utilized a second, more conservative set of assumptions for purposes of determining whether deferred tax valuation allowances were necessary when applying the provisions of Statement 109. In this case, the staff objected to the use of inconsistent assumptions.

In addition to disclosure of key assumptions used in the development of cash flow projections, the staff also has required discussion in MD&A of the implications of assumptions. For example, do the projections indicate that a company is likely to violate debt covenants in the future? What are the ramifications to the cash flow projections used in the impairment analysis? If growth rates used in the impairment analysis are lower than those used by outside analysts, has the company had discussions with the analysts regarding their overly optimistic projections? Has the company appropriately informed the market and its shareholders of its reduced expectations for the future that are sufficient to cause an impairment

charge? The staff believes that cash flow projections used in the impairment analysis must be both internally consistent with the company's other projections and externally consistent with financial statement and other public disclosures.

Topic 6: Interpretations of Accounting Series Releases and Financial Reporting Releases

A.1. Deleted by SAB 103

B. Accounting Series Release 280—General Revision of Regulation S-X: Income or Loss Applicable to Common Stock

Facts: A registrant has various classes of preferred stock. Dividends on those preferred stocks and accretions of their carrying amounts cause income applicable to common stock to be less than reported net income.

Question: In ASR 280, the Commission stated that although it had determined not to mandate presentation of income or loss applicable to common stock in all cases, it believes that disclosure of that amount is of value in certain situations. In what situations should the amount be reported, where should it be reported, and how should it be computed?

Interpretive Response: Income or loss applicable to common stock should be reported on the face of the income statement¹ when it is materially different in quantitative terms from reported net income or loss² or when it is indicative of significant trends or other qualitative considerations. The amount to be reported should be computed for each period as net income or loss less: (a) Dividends on preferred stock, including undeclared or unpaid dividends if cumulative; and (b) periodic increases in the carrying amounts of instruments reported as redeemable preferred stock (as discussed in Topic 3.C) or increasing rate preferred stock (as discussed in Topic 5.Q).

¹ If a registrant elects to follow the encouraged disclosure discussed in paragraph 23 of Statement 130, and displays the components of other comprehensive income and the total for comprehensive income using a one-statement approach, the registrant must continue to follow the guidance set forth in the SAB Topic. One approach may be to provide a separate reconciliation of net income to income available to common stock below comprehensive income reported on a statement of income and comprehensive income.

² The assessment of materiality is the responsibility of each registrant. However, absent concerns about trends or other qualitative considerations, the staff generally will not insist on the reporting of income or loss applicable to common stock if the amount differs from net income or loss by less than ten percent.

C. Accounting Series Release 180—Institution of Staff Accounting Bulletins (SABs)—Applicability of Guidance Contained in SABs

Facts: The series of SABs was instituted to achieve wide dissemination of administrative interpretations and practices of the Commission's staff. In illustration of certain interpretations and practices, SABs may be written narrowly to describe the circumstances of particular matters which resulted in expression of the staff's views on those particular matters.

Question: How does the staff intend SABs to be applied in circumstances analogous to those addressed in SABs?

Interpretive Response: The staff's purpose in issuing SABs is to disseminate guidance for application not only in the narrowly described circumstances, but also, unless authoritative accounting literature calls for different treatment, in other circumstances where events and transactions have similar accounting and/or disclosure implications.

Registrants and independent accountants are encouraged to consult with the staff if they believe that particular circumstances call for accounting and/or disclosure different from that which would result from application of a SAB addressing those same or analogous circumstances.

D. Redesignated as Topic 12.A by SAB 47

E. Redesignated as Topic 12.B by SAB 47

F. Deleted by SAB 103

G. Accounting Series Releases 177 and 286—Relating to Amendments To Form 10-Q, Regulation S-K, and Regulation S-X Regarding Interim Financial Reporting

General Facts: Disclosure requirements for quarterly data on Form 10-Q were amended in ASR 177 and 286 to include condensed interim financial statements, a narrative analysis of financial condition and results of operations, a letter from the registrant's independent public accountant commenting on any accounting change, and a signature by the registrant's chief financial officer or chief accounting officer.¹ In addition, certain selected quarterly data is required to be disclosed by virtually all registrants (see Item 302(a)(5) of Regulation S-K).

¹ These requirements have been further revised to require the company's CEO and CFO to certify to the information contained in the company's periodic filing.

1. Selected Quarterly Financial Data (Item 302(A) of Regulation S-K)

a. Disclosure of Selected Quarterly Financial Data

Facts: Item 302(a)(1) of Regulation S-K requires disclosure of net sales, gross profit, income before extraordinary items and cumulative effect of a change in accounting, per share data based upon such income, and net income for each full quarter within the two most recent fiscal years and any subsequent interim period for which financial statements are included. Item 302(a)(3) requires the registrant to describe the effect of any disposals of components of an entity¹ and extraordinary, unusual or infrequently occurring items recognized in each quarter, as well as the aggregate effect and the nature of year-end or other adjustments which are material to the results of that quarter. Furthermore, Item 302(a)(2) requires a reconciliation of amounts previously reported on Form 10-Q to the quarterly data presented if the amounts differ.

Question 1: Are these disclosure requirements applicable to supplemental financial statements included in a filing with the SEC for unconsolidated subsidiaries and 50% or less owned persons?

Interpretive Response: The summarized quarterly financial data required by Item 302(a)(1) need not be included in supplemental financial statements for unconsolidated subsidiaries and 50% or less owned persons unless the financial statements are for a subsidiary or affiliate that is itself a registrant which meets the criteria set forth in Item 302(a)(5).

Question 2: If a company is in a specialized industry where "gross profit" generally is not computed (e.g., banks, insurance companies and finance companies), what disclosure should be made to comply with the requirements of Item 302(a)(1)?

Interpretive Response: Companies in specialized industries should present summarized quarterly financial data which are most meaningful in their particular circumstances. For example, a bank might present interest income, interest expense, provision for loan losses, security gains or losses and net income. Similarly, an insurance company might present net premiums earned, underwriting costs and expenses, investment income, security gains or losses and net income.

Question 3: If a company wishes to make its quarterly and annual

¹ See question 5 for a discussion of the meaning of components of an entity as used in Item 302(a)(2).

disclosures on the same basis, would disclosure of costs and expenses associated directly with or allocated to products sold or services rendered, or other appropriate data to enable users to compute "gross profit," satisfy the requirements of Item 302(a)(1)?

Interpretive Response: Yes.

Question 4: What is meant by "per share data based upon such income" as used in Item 302(a)(1)?

Interpretive Response: Item 302(a)(1) only requires disclosure of per share amounts for income before extraordinary items and cumulative effect of a change in accounting. It is expected that when per share data is calculated for each full quarter based upon such income, the per share amounts would be both basic and diluted. Although it is not required by the rule, there are many instances where it would be desirable to disclose other per share figures such as net earnings per share and the per share effect of extraordinary items also. Where such disclosure is made, per share data should be both basic and diluted.

Question 5: What is intended by the requirement set forth in Item 302(a)(3) that registrants "describe the effect of" disposals of segments of a business, etc.?

Interpretive Response: The rule uses the language of segments of a business that was previously found in the authoritative literature. Consistent with the terminology used in Statement 144, as used here, segments of a business is intended to mean components of an entity. The rule is intended to require registrants to "disclose the amount" of such unusual transactions and events included in the results reported for each quarter. Such disclosure would be made in narrative form. However, it would not require that matters covered by MD&A be repeated. In this situation, registrants should disclose the nature and amount of the unusual transaction or event and refer to MD&A for further discussion of the matter.

Question 6: What is intended by the requirement of Item 302(a)(3) to disclose "the aggregate effect and the nature of year-end or other adjustments which are material to the results of that quarter"?

Interpretive Response: This language is taken directly from paragraph 31 of APB Opinion 28 which relates to disclosures required for the fourth quarter of the year. The Opinion indicates that earlier quarters should not be restated to reflect a change in accounting estimate recorded at year end. However, changes in an accounting estimate made in an interim period that materially affect the quarter in which the change occurred are required to be

disclosed in order to avoid misleading comparisons. In making such disclosure, registrants may wish to identify (but not restate) the prior periods in which transactions were recorded which relate to the change in the quarter.

Question 7: If company has filed a Form 10-Q/A amending a previously filed Form 10-Q, is a reconciliation of quarterly data in annual financial statements with the amounts originally reported on Form 10-Q required?

Interpretive Response: Yes. However, if the company publishes quarterly reports to shareholders and has previously made detailed disclosure to shareholders in such reports of the change reported on the Form 10-Q/A, no reconciliation would be required.

b. Financial Statements Presented on Other Than a Quarterly Basis

Facts: Item 302(a)(1) requires disclosure of quarterly financial data for each full quarter of the last two fiscal years and in any subsequent interim period for which an income statement is presented.

Question: If a company reports at interim dates on other than a calendar-quarter basis (e.g., 12-12-16-12 week basis), will it be precluded from reporting on such basis in the future?

Interpretive Response: No, as long as it discloses the basis of interim fiscal period reporting and the interim fiscal periods on which it reports are consistently determined from year to year (or, if not, the lack of comparability is disclosed).

c. Deleted by SAB 103

2. Amendments to Form 10-Q

a. Form of Condensed Financial Statements

Facts: Rules 10-01(a)(2) and (3) of Regulation S-X provide that interim balance sheets and statements of income shall include only major captions (i.e., numbered captions) set forth in Regulation S-X, with the exception of inventories where data as to raw materials, work in process and finished goods shall be included, if applicable, either on the face of the balance sheet or in notes thereto. Where any major balance sheet caption is less than 10% of total assets and the amount in the caption has not increased or decreased by more than 25% since the end of the preceding fiscal year, the caption may be combined with others. When any major income statement caption is less than 15% of average net income for the most recent three fiscal years and the amount in the caption has not increased or decreased by more than 20% as

compared to the corresponding interim period of the preceding fiscal year, the caption may be combined with others. Similarly, the statement of cash flows may be abbreviated, starting with a single figure of cash flows provided by operations and showing other changes individually only when they exceed 10% of the average of cash flows provided by operations for the most recent three years.

Question 1: If a company previously combined captions in a Form 10-Q but is required to present such captions separately in the Form 10-Q for the current quarter, must it retroactively reclassify amounts included in the prior-year financial statements presented for comparative purposes to conform with the captions presented for the current-year quarter?

Interpretive Response: Yes.

Question 2: In determining whether or not major income statement captions may be combined, does average "net income" for the last three years (using the company's last year end as the starting point) mean "net income" or income before extraordinary items and changes in accounting principles?

Interpretive Response: It means "net income."

Question 3: If a company uses the gross profit method or some other method to determine cost of goods sold for interim periods, will it be acceptable to state only that it is not practicable to determine components of inventory at interim periods?

Interpretive Response: The staff believes disclosure of inventory components is important to investors. In reaching this decision the staff recognizes that registrants may not take inventories during interim periods and that managements, therefore, will have to estimate the inventory components. However, the staff believes that management will be able to make reasonable estimates of inventory components based upon their knowledge of the company's production cycle, the costs (labor and overhead) associated with this cycle as well as the relative sales and purchasing volume of the company.

Question 4: If a company has years during which operations resulted in a net outflow of cash and cash equivalents, should it exclude such years from the computation of cash and cash equivalents provided by operations for the three most recent years in determining what sources and applications must be shown separately?

Interpretive Response: Yes. Similar to the determination of average net income, if operations resulted in a net outflow of cash and cash equivalents

during any year, such amount should be excluded in making the computation of cash flow provided by operations for the three most recent years unless operations resulted in a net outflow of cash and cash equivalents in all three years, in which case the average of the net outflow of cash and cash equivalents should be used for the test.

A. Reporting Requirements for accounting Changes

1. Preferability

Facts: Rule 10-01(b)(6) of Regulation S-X requires that a registrant who makes a material change in its method of accounting shall indicate the date of and the reason for the change. The registrant also must include as an exhibit in the first Form 10-Q filed subsequent to the date of an accounting change, a letter from the registrant's independent accountants indicating whether or not the change is to an alternative principle which in his judgment is preferable under the circumstances. A letter from the independent accountant is not required when the change is made in response to a standard adopted by the Financial Accounting Standards Board which requires such a change.

Question 1: For some alternative accounting principles, authoritative bodies have specified when one alternative is preferable to another. However, for other alternative accounting principles, no authoritative body has specified criteria for determining the preferability of one alternative over another. In such situations, how should preferability be determined?

Interpretive Response: In such cases, where objective criteria for determining the preferability among alternative accounting principles have not been established by authoritative bodies, the determination of preferability should be based on the particular circumstances described by and discussed with the registrant. In addition, the independent accountant should consider other significant information of which he is aware.¹

Question 2: Management may offer, as justification for a change in accounting principle, circumstances such as: Their expectation as to the effect of general economic trends on their business (e.g., the impact of inflation), their

¹ Registrants also are reminded that paragraph 17 of APB Opinion 20 requires that companies disclose the nature of and justification for the change as well as the effects of the change on net income for the period in which the change is made. Furthermore, the justification for the change should explain clearly why the newly adopted principle is preferable to the previously-applied principle.

expectation regarding expanding consumer demand for the company's products, or plans for change in marketing methods. Are these circumstances which enter into the determination of preferability?

Interpretive Response: Yes. Those circumstances are examples of business judgment and planning and should be evaluated in determining preferability. In the case of changes for which objective criteria for determining preferability have not been established by authoritative bodies, business judgment and business planning often are major considerations in determining that the change is to a preferable method because the change results in improved financial reporting.

Question 3: What responsibility does the independent accountant have for evaluating the business judgment and business planning of the registrant?

Interpretive Response: Business judgment and business planning are within the province of the registrant. Thus, the independent accountant may accept the registrant's business judgment and business planning and express reliance thereon in his letter. However, if either the plans or judgment appear to be unreasonable to the independent accountant, he should not accept them as justification. For example, an independent accountant should not accept a registrant's plans for a major expansion if he believes the registrant does not have the means of obtaining the funds necessary for the expansion program.

Question 4: If a registrant, who has changed to an accounting method which was preferable under the circumstances, later finds that it must abandon its business plans or change its business judgment because of economic or other factors, is the registrant's justification nullified?

Interpretive Response: No. A registrant must in good faith justify a change in its method of accounting under the circumstances which exist at the time of the change. The existence of different circumstances at a later time does not nullify the previous justification for the change.

Question 5: If a registrant justified a change in accounting method as preferable under the circumstances, and the circumstances change, may the registrant revert to the method of accounting used before the change?

Interpretive Response: Any time a registrant makes a change in accounting method, the change must be justified as preferable under the circumstances. Thus, a registrant may not change back to a principle previously used unless it can justify that the previously used

principle is preferable in the circumstances as they currently exist.

Question 6: If one client of an independent accounting firm changes its method of accounting and the accountant submits the required letter stating his view of the preferability of the principle in the circumstances, does this mean that all clients of that firm are constrained from making the converse change in accounting (e.g., if one client changes from FIFO to LIFO, can no other client change from LIFO to FIFO)?

Interpretive Response: No. Each registrant must justify a change in accounting method on the basis that the method is preferable under the circumstances of that registrant. In addition, a registrant must furnish a letter from its independent accountant stating that in the judgment of the independent accountant the change in method is preferable under the circumstances of that registrant. If registrants in apparently similar circumstances make changes in opposite directions, the staff has a responsibility to inquire as to the factors which were considered in arriving at the determination by each registrant and its independent accountant that the change was preferable under the circumstances because it resulted in improved financial reporting. The staff recognizes the importance, in many circumstances, of the judgments and plans of management and recognizes that such management judgments may, in good faith, differ. As indicated above, the concern relates to registrants in apparently similar circumstances, no matter who their independent accountants may be.

Question 7: If a registrant changes its accounting to one of two methods specifically approved by the FASB in a Statement of Financial Accounting Standards, need the independent accountant express his view as to the preferability of the method selected?

Interpretive Response: If a registrant was formerly using a method of accounting no longer deemed acceptable, a change to either method approved by the FASB may be presumed to be a change to a preferable method and no letter will be required from the independent accountant. If, however, the registrant was formerly using one of the methods approved by the FASB for current use and wishes to change to an alternative approved method, then the registrant must justify its change as being one to a preferable method in the circumstances and the independent accountant must submit a letter stating that in his view the change is to a principle that is preferable in the circumstances.

2. Filing of a Letter From the Accountants

Facts: The registrant makes an accounting change in the fourth quarter of its fiscal year. Rule 10-01(b)(6) of Regulation S-X requires that the registrant file a letter from its independent accountants stating whether or not the change is preferable in the circumstances in the next Form 10-Q. Item 601(b)(18) of Regulation S-K provides that the independent accountant's preferability letter be filed as an exhibit to reports on Forms 10-K or 10-Q.

Question: When the independent accountant's letter is filed with the Form 10-K, must another letter also be filed with the first quarter's Form 10-Q in the following year?

Interpretive Response: No. A letter is not required to be filed with Form 10-Q if it has been previously filed as an exhibit to the Form 10-K.

H. Accounting Series Release 148—Disclosure Of Compensating Balances And Short-Term Borrowing Arrangements (Adopted November 13, 1973 As Modified By ASR 172 Adopted On June 13, 1975 And ASR 280 Adopted On September 2, 1980)

Facts: ASR 148 (as modified) amends Regulation S-X to include:

1. Disclosure of compensating balance arrangements.
2. Segregation of cash for compensating balance arrangements that are legal restrictions on the availability of cash.

1. Applicability

a. Arrangements With Other Lending Institutions

Question: In addition to banks, is ASR 148 applicable to arrangements with factors, commercial finance companies or other lending entities?

Interpretive Response: Yes.

b. Bank Holding Companies and Brokerage Firms

Question: Do the provisions of ASR 148 apply to bank holding companies and to brokerage firms filing under Rule 17a-5?

Interpretive Response: Yes; however, brokerage firms are not expected to meet these requirements when filing Form X-17a-5.

c. Financial Statements of Parent Company and Unconsolidated Subsidiaries

Question: Are the provisions of ASR 148 applicable to parent company financial statements in addition to consolidated financial statements? To

financial statements of unconsolidated subsidiaries?

Interpretive Response: ASR 148 data for consolidated financial statements only will generally be sufficient when a filing includes consolidated and parent company financial statements. Such data are required for each unconsolidated subsidiary or other entity when a filing is required to include complete financial statements of those entities. When the filing includes summarized financial data in a footnote about such entities, the disclosures under ASR 148 relating to the consolidated financial statements will be sufficient.

d. Foreign Lenders

Question: Are ASR 148 disclosure requirements applicable to arrangements with foreign lenders?

Interpretive Response: Yes.

2. Classification of Short-Term Obligations—Debt Related to Long-Term Projects

Facts: Companies engaging in significant long-term construction programs frequently arrange for revolving cover loans which extend until the completion of long-term construction projects. Such revolving cover loans are typically arranged with substantial financial institutions and typically have the following characteristics:

1. A firm long-term mortgage commitment is obtained for each project.
2. Interest rates and terms are in line with the company's normal borrowing arrangements.
3. Amounts are equal to the expected full mortgage amount of all projects.
4. The company may draw down funds at its option up to the maximum amount of the agreement.
5. The company uses short-term interim construction financing (commercial paper, bank loans, etc.) against the revolving cover loan. Such indebtedness is rolled over or drawn down on the revolving cover loan at the company's option. The company typically has regular bank lines of credit, but these generally are not legally enforceable.

Question: Under Statement 6, will the classification of loans such as described above as long-term be acceptable?

Interpretive Response: Where such conditions exist providing for a firm commitment throughout the construction program as well as a firm commitment for permanent mortgage financing, and where there are no contingencies other than the completion of construction, the guideline criteria are met and the borrowing under such

a program should be classified as long-term with appropriate disclosure.

3. Compensating Balances

a. Compensating Balances for Future Credit Availability

Facts: Rule 5–02.1 of Regulation S–X requires disclosure of compensating balances in order to avoid undisclosed commingling of such balances with other funds having different liquidity characteristics and bearing no determinable relationship to borrowing arrangements. It also requires footnote disclosure distinguishing the amounts of such balances maintained under a formal agreement to assure future credit availability.

Question: In disclosing compensating balances maintained to assure future credit availability, is it necessary to segregate compensating balances for an unused portion of a regular line of credit when a total compensating balance amount covering both used and unused amounts of a line of credit is disclosed?

Interpretive Response: No.

b. Changes in Compensating Balances

Facts: ASR 148 guidelines indicate the need for additional disclosures where compensating balances were materially greater during the period than at the end of the period.

Question: Does this disclosure relate to changes in the arrangement (e.g., the required compensating balance percentage) or changes in borrowing levels?

Interpretive Response: Both.

c. Float

Facts: ASR 148 states that “compensating balance arrangements * * * are normally expressed in terms of collected bank ledger balances but the financial statements are presented on the basis of the company's books. In order to make the disclosure of compensating balance amounts * * * consistent with the cash amounts reflected in the financial statements, the balance figure agreed upon by the bank and the company should be adjusted if possible by the estimated float.”

Question: In determining the amount of “float” as suggested by ASR 148 guidelines, frequently an adjustment to the bank balance is required for “uncollected funds.” On what basis should this adjustment be estimated?

Interpretive Response: The adjustment should be estimated based upon the method used by the bank or a reasonable approximation of that method. The following is a sample computation of the amount of compensating balances to be disclosed where uncollected funds are involved.

Assumptions: The company has agreed to maintain compensating balances equal to 20% of short-term borrowings.

Short-term borrowings	\$10,000,000
Compensating balances per bank balances	2,000,000
Estimated float (approximates the excess of outstanding checks over deposits in transit)	480,000
Estimated uncollected funds	320,000
<i>Computation:</i>	
Compensating balances per bank balances	2,000,000
Estimated uncollected funds	320,000
Estimated float	(480,000)
Compensating balances stated in terms of a book cash balance and to be disclosed ...	1,840,000

4. Miscellaneous

a. Periods Required

Question: For what periods are ASR 148 disclosures required?

Interpretive Response: Disclosure of compensating balance arrangements and other disclosures called for in ASR 148 are required for the latest fiscal year but are generally not required for any later interim period unless a material change has occurred since year end.

b. 10–Q Disclosures

Question: Are ASR 148 disclosures required in 10–Q's?

Interpretive Response: In general, ASR 148 disclosures are not required in Form 10–Q. However, in some instances material changes in borrowing arrangements or borrowing levels may give rise to the need for disclosure either in Form 10–Q or Form 8–K.

I. Accounting Series Release 149—Improved Disclosure of Income Tax Expense (Adopted November 28, 1973 And Modified by ASR 280 Adopted on September 2, 1980)

Facts: ASR 149 and 280 amend Regulation S–X to include:

1. Disclosure of tax effect of timing differences comprising deferred income tax expense.
2. Disclosure of the components of income tax expense, including currently payable and the net tax effects of timing differences.
3. Disclosure of the components of income [loss] before income tax expense [benefit] as either domestic or foreign.
4. Reconciliation between the statutory Federal income tax rate and the effective tax rate.

1. Tax Rate

Question 1: In reconciling to the effective tax rate should the rate used be a combination of state and Federal income tax rates?

Interpretive Response: No, the reconciliation should be made to the Federal income tax rate only.

Question 2: What is the "applicable statutory Federal income tax rate"?

Interpretive Response: The applicable statutory Federal income tax rate is the normal rate applicable to the reporting entity. Hence, the statutory rate for a U.S. partnership is zero. If, for example, the statutory rate for U.S. corporations is 22% on the first \$25,000 of taxable income and 46% on the excess over \$25,000, the "normalized rate" for corporations would fluctuate in the range between 22% and 46% depending on the amount of pretax accounting income a corporation has.

2. Taxes of Investee Company

Question: If a registrant records its share of earnings or losses of a 50% or less owned person on the equity basis and such person has an effective tax rate which differs by more than 5% from the applicable statutory Federal income tax rate, is a reconciliation as required by Rule 4-08(g) necessary?

Interpretive Response: Whenever the tax components are known and material to the investor's (registrant's) financial position or results of operations, appropriate disclosure should be made. In some instances where 50% or less owned persons are accounted for by the equity method of accounting in the financial statements of the registrant, the registrant may not know the rate at which the various components of income are taxed and it may not be practicable to provide disclosure concerning such components.

It should also be noted that it is generally necessary to disclose the aggregate dollar and per-share effect of situations where temporary tax exemptions or "tax holidays" exist, and that such disclosures are also applicable to 50% or less owned persons. Such disclosures should include a brief description of the factual circumstances and give the date on which the special tax status will terminate. See Topic 11.C.

3. Net of Tax Presentation

Question: What disclosure is required when an item is reported on a net of tax basis (e.g., extraordinary items, discontinued operations, or cumulative adjustment related to accounting change)?

Interpretive Response: When an item is reported on a net of tax basis,

additional disclosure of the nature of the tax component should be provided by reconciling the tax component associated with the item to the applicable statutory Federal income tax rate or rates.

4. Loss Years

Question: Is a reconciliation of a tax recovery in a loss year required?

Interpretive Response: Yes, in loss years the actual book tax benefit of the loss should be reconciled to expected normal book tax benefit based on the applicable statutory Federal income tax rate.

5. Foreign Registrants

Question 1: Occasionally, reporting foreign persons may not operate under a normal income tax base rate such as the current U.S. Federal corporate income tax rate. What form of disclosure is acceptable in these circumstances?

Interpretive Response: In such instances, reconciliations between year-to-year effective rates or between a weighted average effective rate and the current effective rate of total tax expense may be appropriate in meeting the requirements of Rule 4-08(h)(2). A brief description of how such a rate was determined would be required in addition to other required disclosures. Such an approach would not be acceptable for a U.S. registrant with foreign operations. Foreign registrants with unusual tax situations may find that these guidelines are not fully responsive to their needs. In such instances, registrants should discuss the matter with the staff.

Question 2: Where there are significant reconciling items that relate in significant part to foreign operations as well as domestic operations, is it necessary to disclose the separate amounts of the tax component by geographical area, e.g., statutory depletion allowances provided for by U.S. and by other foreign jurisdictions?

Interpretive Response: It is not practicable to give an all-encompassing answer to this question. However, in many cases such disclosure would seem appropriate.

6. Securities Gains and Losses

Question: If the tax on the securities gains and losses of banks and insurance companies varies by more than 5% from the applicable statutory Federal income tax rate, should a reconciliation to the statutory rate be provided?

Interpretive Response: Yes.

7. Tax Expense Components v. "Overall" Presentation

Facts: Rule 4-08(h) requires that the various components of income tax expense be disclosed, e.g., currently payable domestic taxes, deferred foreign taxes, etc. Frequently income tax expense will be included in more than one caption in the financial statements. For example, income taxes may be allocated to continuing operations, discontinued operations, extraordinary items, cumulative effects of an accounting change and direct charges and credits to shareholders' equity.

Question: In instances where income tax expense is allocated to more than one caption in the financial statements, must the components of income tax expense included in each caption be disclosed or will an "overall" presentation such as the following be acceptable?

The components of income tax expense are:

Currently payable (per tax return):	
Federal	\$350,000
Foreign	150,000
State	50,000
Deferred:	
Federal	125,000
Foreign	75,000
State	50,000
	800,000

Income tax expense is included in the financial statements as follows:

Continuing operations	\$600,000
Discontinued operations	(200,000)
Extraordinary income	300,000
Cumulative effect of change in accounting principle	100,000
	800,000

Interpretive Response: An overall presentation of the nature described will be acceptable.

J. Deleted by SAB 47

K. Accounting Series Release 302—*Separate Financial Statements Required By Regulation S-X*

1. Deleted by SAB 103

2. Parent Company Financial Information

a. Computation of Restricted Net Assets of Subsidiaries

Facts: The revised rules for parent company disclosures adopted in ASR 302 require, in certain circumstances, (1) footnote disclosure in the consolidated financial statements about the nature and amount of significant restrictions on the ability of subsidiaries

to transfer funds to the parent through intercompany loans, advances or cash dividends [Rule 4-08(e)(3)], and (2) the presentation of condensed parent company financial information and other data in a schedule (Rule 12-04). To determine which disclosures, if any, are required, a registrant must compute its proportionate share of the net assets of its consolidated and unconsolidated subsidiary companies as of the end of the most recent fiscal year which are restricted as to transfer to the parent company because the consent of a third party (a lender, regulatory agency, foreign government, etc.) is required. If the registrant's proportionate share of the restricted net assets of consolidated subsidiaries exceeds 25% of the registrant's consolidated net assets, both the footnote and schedule information are required. If the amount of such restrictions is less than 25%, but the sum of these restrictions plus the amount of the registrant's proportionate share of restricted net assets of unconsolidated subsidiaries plus the registrant's equity in the undistributed earnings of 50% or less owned persons (investees) accounted for by the equity method exceed 25% of consolidated net assets, the footnote disclosure is required.

Question 1: How are restricted net assets of subsidiaries computed?

Interpretative Response: The calculation of restricted net assets requires an evaluation of each

subsidiary to identify any circumstances where third parties may limit the subsidiary's ability to loan, advance or dividend funds to the parent. This evaluation normally comprises a review of loan agreements, statutory and regulatory requirements, etc., to determine the dollar amount of each subsidiary's restrictions. The related amount of the subsidiary's net assets designated as restricted, however, should not exceed the amount of the subsidiary's net assets included in consolidated net assets, since parent company disclosures are triggered when a significant amount of consolidated net assets are restricted. The amount of each subsidiary's net assets included in consolidated net assets is determined by allocating (pushing down) to each subsidiary any related consolidation adjustments such as intercompany balances, intercompany profits, and differences between fair value and historical cost arising from a business combination accounted for as a purchase. This amount is referred to as the subsidiary's adjusted net assets. If the subsidiary's adjusted net assets are less than the amount of its restrictions because the push down of consolidating adjustments reduced its net assets, the subsidiary's adjusted net assets is the amount of the subsidiary's restricted net assets used in the tests.

Registrants with numerous subsidiaries and investees may wish to

develop approaches to facilitate the determination of its parent company disclosure requirements. For example, if the parent company's adjusted net assets (excluding any interest in its subsidiaries) exceed 75% of consolidated net assets, or if the total of all of the registrant's consolidated and unconsolidated subsidiaries' restrictions and its equity in investees' earnings is less than 25% of consolidated net assets, then the allocation of consolidating adjustments to the subsidiaries to determine the amount of their adjusted net assets would not be necessary since no parent company disclosures would be required.

Question 2: If a registrant makes a decision that it will permanently reinvest the undistributed earnings of a subsidiary, and thus does not provide for income taxes thereon because it meets the criteria set forth in APB Opinion 23, is there considered to be a restriction for purposes of the test?

Interpretative Response: No. The rules require that only third party restrictions be considered. Restrictions on subsidiary net assets imposed by management are not included.

b. Application of Tests for Parent Company Disclosures

Facts: The balance sheet of the registrant's 100%-owned subsidiary at the most recent fiscal year-end is summarized as follows:

Current assets	\$120	Current liabilities	\$30
Noncurrent assets	45	Long-term debt	60
			90
		Common stock	25
		Retained earnings	50
			75
	\$165		\$165

Net assets of the subsidiary are \$75. Assume there are no consolidating adjustments to be allocated to the subsidiary. Restrictive covenants of the

subsidiary's debt agreements provide that:

- Net assets, excluding intercompany loans, cannot be less than \$35

- 60% of accumulated earnings must be maintained

Question 1: What is the amount of the subsidiary's restricted net assets?

Interpretative Response:

Restriction	Computed restrictions
Net assets: currently \$75, cannot be less than \$35; therefore	\$35
Dividends: 60% of accumulated earnings (\$50) cannot be paid out; therefore	30

Restricted net assets for purposes of the test are \$35. The maximum amount that can be loaned or advanced to the parent without violating the net asset covenant is \$40 (\$75-\$35). Alternatively,

the subsidiary could pay a dividend of up to \$20 (\$50-\$30) without violating the dividend covenant, and loan or advance up to \$20, without violating the net asset provision.

Facts: The registrant has one 100%-owned subsidiary. The balance sheet of the subsidiary at the latest fiscal year-end is summarized as follows:

Current assets	\$ 75	Current liabilities	\$ 23
Noncurrent assets	90	Long-term debt	57
		Redeemable preferred stock	10
		Common stock	30
		Retained earnings	45
			
			75
	\$165		\$165

Assume that the registrant's consolidated net assets are \$130 and there are no consolidating adjustments to be allocated to the subsidiary. The subsidiary's net assets are \$75. The subsidiary's noncurrent assets are comprised of \$40 in operating plant and equipment used in the subsidiary's business and a \$50 investment in a 30% investee. The subsidiary's equity in this investee's undistributed earnings is \$18. Restrictive covenants of the subsidiary's debt agreements are as follows:

1. Net assets, excluding intercompany balances, cannot be less than \$20.
2. 80% of accumulated earnings must be reinvested in the subsidiary.
3. Current ratio of 2:1 must be maintained.

Question 2: Are parent company footnote or schedule disclosures required?

Interpretive Response: Only the parent company footnote disclosures are required. The subsidiary's restricted net assets are computed as follows:

Restriction	Computed restriction
Net assets: currently \$75, cannot be less than \$20; therefore	\$20
Dividends: 80% of accumulated earnings (\$45) cannot be paid; therefore	36
Current ratio: must be at least 2:1 (\$46 current assets must be maintained since current liabilities are \$23 at fiscal year-end); therefore	46

Restricted net assets for purposes of the test are \$20. The amount computed from the dividend restriction (\$36) and the current ratio requirement (\$46) are not used because net assets may be transferred by the subsidiary up to the limitation imposed by the requirement to maintain net assets of at least \$20, without violating the other restrictions. For example, a transfer to the parent of up to \$55 of net assets could be accomplished by a combination of

dividends of current assets of \$9 (\$45–36), and loans or advances of current assets of up to \$20 and noncurrent assets of up to \$26.

Parent company footnote disclosures are required in this example since the restricted net assets of the subsidiary and the registrant's equity in the earnings of its 100%-owned subsidiary's investee exceed 25% of consolidated net assets $[(\$20 + 18)/\$130 = 29\%]$. The parent company schedule information is not required since the restricted net assets of the subsidiary are only 15% of consolidated net assets $(\$20/\$130 = 15\%)$.

Although the subsidiary's noncurrent assets are not in a form which is readily transferable to the parent company, the illiquid nature of the assets is not relevant for purposes of the parent company tests. The objective of the tests is to require parent company disclosures when the parent company does not have control of its subsidiaries' funds because it does not have unrestricted access to their net assets. The tests trigger parent company disclosures only when there are significant third party restrictions on transfers by subsidiaries of net assets and the subsidiaries' net assets comprise a significant portion of consolidated net assets. Practical limitations, other than third party restrictions on transferability at the measurement date (most recent fiscal year-end), such as subsidiary illiquidity, are not considered in computing restricted net assets. However, the potential effect of any limitations other than those imposed by third parties should be considered for inclusion in Management's Discussion and Analysis of liquidity.

Facts:

	Net assets
Subsidiary A	\$(500)
Subsidiary B	2,000
Consolidated	3,700

Subsidiaries A and B are 100% owned by the registrant. Assume there are no

consolidating adjustments to be allocated to the subsidiaries. Subsidiary A has restrictions amounting to \$200. Subsidiary B's restrictions are \$1,000.

Question 3: What parent company disclosures are required for the registrant?

Interpretive Response: Since subsidiary A has an excess of liabilities over assets, it has no restricted net assets for purposes of the test. However, both parent company footnote and schedule disclosures are required, since the restricted net assets of subsidiary B exceed 25% of consolidated net assets $(\$1,000/3,700 = 27\%)$.

Facts:

	Net assets
Subsidiary A	\$850
Subsidiary B	300
Consolidated	3,700

The registrant owns 80% of subsidiary A. Subsidiary A owns 100% of subsidiary B. Assume there are no consolidating adjustments to be allocated to the subsidiaries. A may not pay any dividends or make any affiliate loans or advances. B has no restrictions. A's net assets of \$850 do not include its investment in B.

Question 4: Are parent company footnote or schedule disclosures required for this registrant?

Interpretive Response: No. All of the registrant's share of subsidiary A's net assets (\$680) are restricted. Although B may pay dividends and loan or advance funds to A, the parent's access to B's funds through A is restricted. However, since there are no limitations on B's ability to loan or advance funds to the parent, none of the parent's share of B's net assets are restricted. Since A's restricted net assets are less than 25% of consolidated net assets $(\$680/3700 = 18\%)$, no parent company disclosures are required.

Facts: The consolidating balance sheet of the registrant at the latest fiscal year-end is summarized as follows:

	Registrant	Subsidiary	Consolidating adjustments	Consolidated
Current assets	\$ 800	\$ 700	\$ 0	\$1,500
30% investment in affiliate	175	0	0	175
Investment in subsidiary	350	0	(350)	0
Other noncurrent assets	625	300	(100)	825
	\$1,950	\$1,000	\$ (450)	\$2,500
Current liabilities	\$ 600	\$ 400	\$ 0	\$1,000
Concurrent liabilities	375	150	0	525
Redeemable preferred stock	275	0	0	275
Common stock	110	1	(1)	110
Paid-in capital	290	49	(49)	290
Retained earnings	300	400	(400)	300
	700	450	(450)	700
	\$1,950	\$1,000	\$ (450)	\$2,500

The acquisition of the 100%-owned subsidiary was consummated on the last day of the most recent fiscal year. Immediately preceding the acquisition, the registrant had net assets of \$700, which included its equity in the undisputed earnings of its 30% investee of \$75. Immediately after acquiring the subsidiary's net assets, which had an historical cost of \$450 and a fair value of \$350, the registrant's net assets were still \$700 since debt and preferred stock totaling \$350 were issued in the purchase. The subsidiary has debt covenants which permit dividends, loans or advances, to the extent, if any, that net assets exceed an amount which is determined by the sum of \$100 plus 75% of the subsidiary's accumulated earnings.

Question 5: What is the amount of the subsidiary's restricted net assets? Are parent company footnote or schedule disclosures required?

Interpretive Response: Restricted net assets for purposes of the test are \$350, and both the parent company footnote and schedule disclosures are required.

The amount of the subsidiary's restrictions at year-end is \$400 [$\$100 + (75\% \times \$400)$]. The subsidiary's adjusted net assets after the push down of the consolidation entry to the subsidiary to record the noncurrent assets acquired at their fair value is \$350 ($\$450 - \100). Since the subsidiary's adjusted net assets (\$350) are less than the amount of its restrictions (\$400), restricted net assets are \$350. The computed percentages applicable to each of the disclosure tests is in excess of 25%. Therefore, both parent company footnote and schedule information are required. The percentage applicable to the footnote disclosure test is 61% [$(\$75 + \$350)/\$700$]. The computed percentage for the schedule disclosure is 50% ($\$350/\700).

3. Undistributed Earnings of 50% or Less Owned Persons

Facts: Rule 4-08(e)(2) of Regulation SX requires footnote disclosures of the amount of consolidated retained earnings which represents undistributed earnings of 50% or less owned persons (investee) accounted for by the equity method. The test adopted in ASR 302 to trigger disclosures about the registrant's restricted net assets (Rule 4-08(e)(3)) includes the parent's equity in the undistributed earnings of investees.

Question: Is the amount required for footnote disclosure the same as the amount included in the test to determine disclosures about restrictions?

Interpretive Response: Yes. The amount used in the test in Rule 4-08(e)(3) should be the same as the amount required to be disclosed by Rule 4-08(e)(2). This is the portion of the registrant's consolidated retained earnings which represents the undistributed earnings of an investee since the date(s) of acquisition. It is computed by determining the registrant's cumulative equity in the investee's earnings, adjusted by any dividends received, related goodwill amortized, and any related income taxes provided.

4. Application of Significant Subsidiary Test to Investees and Unconsolidated Subsidiaries

a. Separate Financial Statement Requirements

Facts: Rule 3-09 of Regulation SX requires the presentation of separate financial statements of unconsolidated subsidiaries and of 50% or less owned persons (investee) accounted for by the equity method either by the registrant or by a subsidiary of the registrant in filings with the Commission if any of the tests of a significant subsidiary are met at a 20% level.

Question 1: Are the requirements for separate financial statements also

applicable to an investee accounted for by the equity method by an investee of the registrant?

Interpretive Response: Yes. Rule 3-09 is intended to apply to all investees which are material to the financial position or results of operations of the registrant, regardless of whether the investee is held by the registrant, a subsidiary or another investee. Separate financial statements should be provided for any lower tier investee where such an entity is significant to the registrant's consolidated financial statements.

Question 2: How is the significant subsidiary test applied to the lower tier investee in the situation described in Question 1?

Interpretive Response: Since the disclosures provided by separate financial statements of an investee are considered necessary to evaluate the overall financial condition of the registrant, the significant subsidiary test is computed based on the materiality of the lower tier investee to the registrant consolidated. An example of the application of the assets test of the significant subsidiary rules to such an investee situation will illustrate the materiality measurement. A registrant with total consolidated assets of \$5,000 owns 50% of Investee A, whose total assets are \$3,800. Investee A has a 45% investment in Investee B, whose total assets are \$4,800. There are no intercompany eliminations. Separate financial statements are required for Investee A, and they are required for Investee B because the registrant's share of B's total assets exceeds 20% of consolidated assets [$(50\% \times 45\% \times \$4800)/\$5000 = 22\%$].

b. Summarized Financial Statement Requirements

Facts: Rule 4-08(g) of Regulation S-X requires summarized financial information about unconsolidated subsidiaries and 50% or less owned persons (investee) to be included in the footnotes to the financial statements if,

in the aggregate, they meet the tests of a significant subsidiary set forth in Rule 1-02(w).

Question 1: Must a registrant which includes separate financial statements or condensed financial statements for unconsolidated subsidiaries or investees in its annual report to shareholders also include in such report the summarized financial information for these entities pursuant to Rule 4-08(g)?

Interpretive Response: No. The purpose of the summarized information is to provide minimum standards of disclosure when the impact of such entities on the consolidated financial statements is significant. If the registrant furnishes more information in the annual report than is required by these minimum disclosure standards, such as condensed financial information or separate audited financial statements, the summarized data can be excluded. The Commission's rules are not intended to conflict with the provisions of APB Opinion 18, par 20(c) and (d), which provide that either separate financial statements of investees be presented with the financial statements of the reporting entity or that summarized information be included in the reporting entity's financial statement footnotes.

Question 2: Can summarized information be omitted for individual entities as long as the aggregate information for the omitted entity(s) does not exceed 10% under any of the significance tests of Rule 1-02(w)?

Interpretive Response: The 10% measurement level of the significant subsidiary rule was not intended to establish a materiality criteria for omission, and the arbitrary exclusion of summarized information for selected entities up to a 10% level is not appropriate. Rule 4-08(g) requires that the summarized information be included for all unconsolidated subsidiaries and investees. However, the staff recognizes that exclusion of the summarized information for certain entities is appropriate in some circumstances where it is impracticable to accumulate such information and the summarized information to be excluded is *de minimis*.

L. Financial Reporting Release 28—Accounting For Loan Losses By Registrants Engaged in Lending Activities

1. Accounting for Loan Losses

General: GAAP for recognition of loan losses is provided by Statements 5 and 114.¹ An estimated loss from a loss

contingency, such as the collectibility of receivables, should be accrued when, based on information available prior to the issuance of the financial statements, it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statements and the amount of the loss can be reasonably estimated.² Statement 114 provides more specific guidance on measurement of loan impairment and related disclosures but does not change the fundamental recognition criteria for loan losses provided by Statement 5. Additional guidance on the recognition, measurement, and disclosure of loan losses is provided by EITF Topic D-80, Interpretation 14, and the AICPA Audit and Accounting Guide, Banks and Savings Institutions.

Further guidance for SEC registrants is provided by FRR 28, which added subsection (b), Procedural Discipline in Determining the Allowance and Provision for Loan Losses to be Reported, of Section 401.09, Accounting for Loan Losses by Registrants Engaged in Lending Activities, to the Codification of Financial Reporting Policies (hereafter referred to as FRR 28). Additionally, public companies are required to comply with the books and records provisions of the Securities Exchange Act of 1934 (Exchange Act). Under Sections 13(b)(2)–(7) of the Exchange Act, registrants must make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of assets of the registrant. Registrants also must maintain internal accounting controls that are sufficient to provide reasonable assurances that, among other things, transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP.

This staff interpretation applies to all registrants that are creditors in loan transactions that, individually or in the aggregate, have a material effect on the registrant's financial statements.³

2. Developing and Documenting a Systematic Methodology

a. Developing a Systematic Methodology

Facts: Registrant A, or one of its consolidated subsidiaries, engages in lending activities and is developing or performing a review of its loan loss allowance methodology.

Question: What are some of the factors or elements that the staff normally would expect Registrant A to consider when developing (or subsequently performing an assessment of) its methodology for determining its loan loss allowance under GAAP?

Interpretive Response: The staff normally would expect a registrant that engages in lending activities to develop and document a systematic methodology¹ to determine its provision for loan losses and allowance for loan losses as of each financial reporting date. It is critical that loan loss allowance methodologies incorporate management's current judgments about the credit quality of the loan portfolio through a disciplined and consistently applied process. A registrant's loan loss allowance methodology is influenced by entity-specific factors, such as an entity's size, organizational structure, business environment and strategy, management style, loan portfolio characteristics, loan administration procedures, and management information systems.

However, as indicated in the AICPA Audit and Accounting Guide, Banks and Savings Institutions (Audit Guide), "[w]hile different institutions may use different methods, there are certain common elements that should be included in any [loan loss allowance] methodology for it to be effective."² A registrant's loan loss allowance methodology generally should:³

- Include a detailed analysis of the loan portfolio, performed on a regular basis;
- Consider all loans (whether on an individual or group basis);
- Identify loans to be evaluated for impairment on an individual basis under Statement 114 and segment the remainder of the portfolio into groups of loans with similar risk characteristics

² Paragraph 8 of Statement 5.

³ For purposes of this interpretation, a loan is defined (consistent with paragraph 4 of Statement 114) as a contractual right to receive money on demand or on fixed or determinable dates that is recognized as an asset in the creditor's statement of financial position. For purposes of this interpretation, loans do not include trade accounts receivable or notes receivable with terms less than one year or debt securities subject to the provisions of Statement 115

¹ FRR 28 states that "the Commission's staff normally would expect to find that the books and records of registrants engaged in lending activities include documentation of [the]: (a) systematic methodology to be employed each period in determining the amount of the loan losses to be reported, and (b) rationale supporting each period's determination that the amounts reported were adequate."

² See paragraph 7.05 of the Audit Guide.

³ *Ibid.*

¹ As amended by Statement 118.

for evaluation and analysis under Statement 5;

- Consider all known relevant internal and external factors that may affect loan collectibility;
- Be applied consistently but, when appropriate, be modified for new factors affecting collectibility;
- Consider the particular risks inherent in different kinds of lending;
- Consider current collateral values (less costs to sell), where applicable;
- Require that analyses, estimates, reviews and other loan loss allowance methodology functions be performed by competent and well-trained personnel;
- Be based on current and reliable data;
- Be well documented, in writing, with clear explanations of the supporting analyses and rationale (see Question 2 below for staff views on documenting a loan loss allowance methodology); and
- Include a systematic and logical method to consolidate the loss estimates and ensure the loan loss allowance balance is recorded in accordance with GAAP.

For many entities engaged in lending activities, the allowance and provision for loan losses are significant elements of the financial statements.

Therefore, the staff believes it is appropriate for an entity's management to review, on a periodic basis, its methodology for determining its allowance for loan losses.⁴ Additionally, for registrants that have audit committees, the staff believes that oversight of the financial reporting and auditing of the loan loss allowance by the audit committee can strengthen the registrant's control system and process for determining its allowance for loan losses.⁵

⁴ For federally insured depository institutions, the December 21, 1993 "Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL)" (the 1993 Interagency Policy Statement) indicates that boards of directors and management have certain responsibilities for the ALLL process and amounts reported. For example, as indicated on page 4 of that statement, "the board of directors and management are expected to: Ensure that the institution has an effective loan review system and controls[;] Ensure the prompt charge-off of loans, or portions of loans, that available information confirms to be uncollectible[;] and] Ensure that the institution's process for determining an adequate level for the ALLL is based on a comprehensive, adequately documented, and consistently applied analysis of the institution's loan and lease portfolio."

⁵ SAS 61 (as amended by SAS 90) states, in part: "In connection with each SEC engagement the auditor should discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the entity's accounting principles as applied in its financial reporting. The discussion should include items that have a significant impact on the representational faithfulness, verifiability, and neutrality of the

A systematic methodology that is properly designed and implemented should result in a registrant's best estimate of its allowance for loan losses.⁶ Accordingly, the staff normally would expect registrants to adjust their loan loss allowance balance, either upward or downward, in each period for differences between the results of the systematic determination process and the unadjusted loan loss allowance balance in the general ledger.⁷

b. Documenting a Systematic Methodology

Question 1: Assume the same facts as in Question 1. What would the staff normally expect Registrant A to include in its documentation of its loan loss allowance methodology?

Interpretive Response: In FRR 28, the Commission provided guidance for documentation of loan loss provisions and allowances for registrants engaged in lending activities. The staff believes that appropriate written supporting documentation for the loan loss provision and allowance facilitates review of the loan loss allowance process and reported amounts, builds discipline and consistency into the loan loss allowance determination process, and improves the process for estimating loan losses by helping to ensure that all relevant factors are appropriately considered in the allowance analysis.

The staff, therefore, normally would expect a registrant to document the relationship between the findings of its detailed review of the loan portfolio and the amount of the loan loss allowance and the provision for loan losses reported in each period.⁸

The staff normally would expect to find that registrants maintain written

accounting information included in the financial statements. [Footnote omitted.] Examples of items that may have such an impact are the following:

- Selection of new or changes to accounting policies
- Estimates, judgments, and uncertainties
- Unusual transactions
- Accounting policies relating to significant financial statement items, including the timing or transactions and the period in which they are recorded."

⁶ Registrants should also refer to Interpretation 14, which provides accounting and disclosure guidance for situations in which a range of loss can be reasonably estimated but no single amount within the range appears to be a better estimate than any other amount within the range.

⁷ Registrants should refer to the guidance on materiality in SAB 99 (SAB Topic 1.M).

⁸ FRR 28 states: "The specific rationale upon which the [loan loss allowance and provision] amount actually reported is based—i.e., the bridge between the findings of the detailed review [of the loan portfolio] and the amount actually reported in each period—would be documented to help ensure the adequacy of the reported amount, to improve auditability, and to serve as a benchmark for exercise of prudent judgment in future periods."

supporting documentation for the following decisions, strategies, and processes:⁹

- Policies and procedures:
- Over the systems and controls that maintain an appropriate loan loss allowance, and
- Over the loan loss allowance methodology;
- Loan grading system or process;
- Summary or consolidation of the loan loss allowance balance;
- Validation of the loan loss allowance methodology; and
- Periodic adjustments to the loan loss allowance process.

Question 2: The Interpretive Response to Question 2 indicates that the staff normally would expect to find that registrants maintain written supporting documentation for their loan loss allowance policies and procedures. In the staff's view, what aspects of a registrant's loan loss allowance internal accounting control systems and processes would appropriately be addressed in its written policies and procedures?

Interpretive Response: The staff is aware that registrants utilize a wide range of policies, procedures, and control systems in their loan loss allowance processes, and these policies, procedures, and systems are tailored to the size and complexity of the registrant and its loan portfolio. However, the staff believes that, in order for a registrant's loan loss allowance methodology to be effective, the registrant's written policies and procedures for the systems and controls that maintain an appropriate loan loss allowance would likely address the following:

- The roles and responsibilities of the registrant's departments and personnel (including the lending function, credit review, financial reporting, internal audit, senior management, audit committee, board of directors, and others, as applicable) who determine or review, as applicable, the loan loss

⁹ Paragraph 7.39 in the Audit Guide outlines specific aspects of effective internal control related to the allowance for loan losses. These specific aspects include the control environment ("management communication of the need for proper reporting of the allowance"); management reports that summarize loan activity and the institution's procedures and controls ("accumulation of relevant, sufficient, and reliable data on which to base management's estimate of the allowance"); "independent loan review;" review of information and assumptions ("adequate review and approval of the allowance estimates by the individuals specified in management's written policy"); assessment of the process ("comparison of prior estimates related to the allowance with subsequent results to assess the reliability of the process used to develop the allowance"); and "consideration by management of whether the allowance is consistent with the operational plans of the institution."

allowance to be reported in the financial statements;¹⁰

- The registrant's accounting policies for loans and loan losses, including the policies for charge-offs and recoveries and for estimating the fair value of collateral, where applicable;¹¹

- The description of the registrant's systematic methodology, which should be consistent with the registrant's accounting policies for determining its loan loss allowance (see Question 4 below for further discussion);¹² and

- The system of internal controls used to ensure that the loan loss allowance process is maintained in accordance with GAAP.¹³

The staff normally would expect an internal control system¹⁴ for the loan loss allowance estimation process to:

- Include measures to provide assurance regarding the reliability¹⁵ and integrity of information and compliance with laws, regulations, and internal policies and procedures;¹⁶

- Reasonably assure that the registrant's financial statements are prepared in accordance with GAAP; and

- Include a well-defined loan review process.¹⁷

¹⁰ Paragraph 7.39 of the Audit Guide discusses "management communication of the need for proper reporting of the allowance." As indicated in that paragraph, the "control environment strongly influences the effectiveness of the system of controls and reflects the overall attitude, awareness, and action of the board of directors and management concerning the importance of control."

¹¹ Paragraph 7.33 of the Audit Guide refers to the documentation, for disclosure purposes, that an entity should include in the notes to the financial statements describing the accounting policies the entity used to estimate its allowance and related provision for loan losses.

¹² *Ibid.* As indicated in paragraph 7.33, "[s]uch a description should identify the factors that influenced management's judgment (for example, historical losses and existing economic conditions) and may also include discussion of risk elements relevant to particular categories of financial instruments."

¹³ See also paragraph 7.39 in the Audit Guide which provides information about specific aspects of effective internal control related to the allowance for loan losses.

¹⁴ *Ibid.* Public companies are required to comply with the books and records provisions of the Exchange Act. Under Sections 13(b)(2)–(7) of the Exchange Act, registrants must make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of assets of the registrant. Registrants also must maintain internal accounting controls that are sufficient to provide reasonable assurances that, among other things, transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP.

¹⁵ Concepts Statement 2 provides guidance on "reliability" as a primary quality of accounting information.

¹⁶ Section 13(b)(2)–(7) of the Exchange Act.

¹⁷ As indicated in paragraph 7.05, item a, in the Audit Guide, a loan loss allowance methodology should "include a detailed and regular analysis of the loan portfolio." Paragraphs 7.06 to 7.13 provide additional information on how creditors

A well-defined loan review process¹⁸ typically contains:

- An effective loan grading system that is consistently applied, identifies differing risk characteristics and loan quality problems accurately and in a timely manner, and prompts

- appropriate administrative actions;¹⁹

- Sufficient internal controls to ensure that all relevant loan review information is appropriately considered in estimating losses. This includes maintaining appropriate reports, details of reviews performed, and identification of personnel involved;²⁰ and

- Clear formal communication and coordination between a registrant's credit administration function, financial reporting group, management, board of directors, and others who are involved in the loan loss allowance determination or review process, as applicable (e.g., written policies and procedures, management reports, audit programs, and committee minutes).²¹

Question 3: The Interpretive Response to Question 3 indicates that the staff normally would expect a registrant's written loan loss allowance policies and procedures to include a description of the registrant's systematic allowance methodology, which should be consistent with its accounting policies for determining its loan loss allowance. What elements of a registrant's loan loss allowance methodology would the staff normally expect to be described in the registrant's written policies and procedures?

Interpretive Response: The staff normally would expect a registrant's written policies and procedures to describe the primary elements of its loan loss allowance methodology, including portfolio segmentation and impairment measurement. The staff normally would expect that, in order for a registrant's loan loss allowance methodology to be effective, the registrant's written policies and

traditionally identify and review loans on an individual basis and review or analyze loans on a group or pool basis.

¹⁸ *Ibid.* Additionally, paragraph 7.39 in the Audit Guide provides guidance on the loan review process. As stated in that paragraph, "[m]anagement reports summarizing loan activity, renewals, and delinquencies are vital to the timely identification of problem loans." The paragraph further states: "Loan reviews should be conducted by institution personnel who are independent of the underwriting, supervision, and collections functions. The specific lines of reporting depend on the complexity of the institution's organizational structure, but the loan reviewers should report to a high level of management that is independent from the lending process in the institution."

¹⁹ *Ibid.*

²⁰ *Ibid.*

²¹ *Ibid.*

procedures would describe the methodology:

- For segmenting the portfolio:

- How the segmentation process is performed (i.e., by loan type, industry, risk rates, etc.);²²

- When a loan grading system is used to segment the portfolio:

- The definitions of each loan grade;

- A reconciliation of the internal loan grades to supervisory loan grades, if applicable; and

- The delineation of responsibilities for the loan grading system.

- For determining and measuring impairment under Statement 114;²³

- The methods used to identify loans to be analyzed individually;

- For individually reviewed loans that are impaired, how the amount of any impairment is determined and measured, including:

- Procedures describing the impairment measurement techniques available; and

- Steps performed to determine which technique is most appropriate in a given situation.

- The methods used to determine whether and how loans individually evaluated under Statement 114, but not considered to be individually impaired, should be grouped with other loans that share common characteristics for impairment evaluation under Statement 5.²⁴

- For determining and measuring impairment under Statement 5;²⁵

- How loans with similar characteristics are grouped to be evaluated for loan collectibility (such as loan type, past-due status, and risk);

- How loss rates are determined (e.g., historical loss rates adjusted for environmental factors or migration analysis) and what factors are considered when establishing appropriate time frames over which to evaluate loss experience; and

- Descriptions of qualitative factors (e.g., industry, geographical, economic,

²² Paragraph 7.07 in the Audit Guide states that "creditors have traditionally identified loans that are to be evaluated for collectibility by dividing the loan portfolio into different segments. Each segment should contain loans with similar characteristics, such as risk classification, past-due status, and type of loan." Paragraph 7.08 provides additional guidance on classifying individual loans and paragraph 7.13 indicates considerations for groups or pools of loans.

²³ See Statement 114, paragraphs 8 through 10 on recognition of impairment and paragraphs 11 through 16 on measurement of impairment. See also the guidance in EITF Topic D-80.

²⁴ See EITF Topic D-80, Exhibit D-80A, Question #10.

²⁵ See Statement 5, paragraphs 8(a) and 8(b) on accrual of loss contingencies and paragraphs 22 and 23 on collectibility of receivables. See also the guidance in EITF Topic D-80.

and political factors) that may affect loss rates or other loss measurements.

3. Applying a Systematic Methodology—Measuring and Documenting Loan Losses Under Statement 114

a. Measuring and Documenting Loan Losses Under Statement 114—General

Facts: Approximately one-third of Registrant B's commercial loan portfolio consists of large balance, non-homogeneous loans. Due to their large individual balances, these loans meet the criteria under Registrant B's policies and procedures for individual review for impairment under Statement 114.

Upon review of the large balance loans, Registrant B determines that certain of the loans are impaired as defined by Statement 114.¹

Question: of the commercial loans reviewed under Statement 114 that are individually impaired, how would the staff normally expect Registrant B to measure and document the impairment on those loans? Can it use an impairment measurement method other than the methods allowed by Statement 114?

Interpretive Response: For those loans that are reviewed individually under Statement 114 and considered individually impaired, Registrant B must use one of the methods for measuring impairment that is specified by Statement 114 (that is, the present value of expected future cash flows, the loan's observable market price, or the fair value of collateral).² Accordingly, in the circumstances described above, for the loans considered individually impaired under Statement 114, it would not be appropriate for Registrant B to choose a measurement method not prescribed by Statement 114. For example, it would not be appropriate to measure loan impairment by applying a loss rate to each loan based on the average historical loss percentage for all of its commercial loans for the past five years.

The staff normally would expect Registrant B to maintain as sufficient, objective evidence³ written documentation to support its measurement of loan impairment under

Statement 114.⁴ If Registrant B uses the present value of expected future cash flows to measure impairment of a loan, it should document the amount and timing of cash flows, the effective interest rate used to discount the cash flows, and the basis for the determination of cash flows, including consideration of current environmental factors⁵ and other information reflecting past events and current conditions. If Registrant B uses the fair value of collateral to measure impairment, the staff normally would expect to find that Registrant B had documented how it determined the fair value, including the use of appraisals, valuation assumptions and calculations, the supporting rationale for adjustments to appraised values, if any, and the determination of costs to sell, if applicable, appraisal quality, and the expertise and independence of the appraiser.⁶ Similarly, the staff normally would expect to find that Registrant B had documented the amount, source, and date of the observable market price of a loan, if that method of measuring loan impairment is used.

b. Measuring and Documenting Loan Losses Under Statement 114 for a Collateral Dependent Loan

Facts: Registrant C has a \$10 million loan outstanding to Company X that is secured by real estate, which Registrant C individually evaluates under Statement 114 due to the loan's size. Company X is delinquent in its loan payments under the terms of the loan agreement. Accordingly, Registrant C determines that its loan to Company X is impaired, as defined by Statement 114. Because the loan is collateral dependent, Registrant C measures impairment of the loan based on the fair value of the collateral. Registrant C determines that the most recent valuation of the collateral was

performed by an appraiser eighteen months ago and, at that time, the estimated value of the collateral (fair value less costs to sell) was \$12 million.

Registrant C believes that certain of the assumptions that were used to value the collateral eighteen months ago do not reflect current market conditions and, therefore, the appraiser's valuation does not approximate current fair value of the collateral.

Several buildings, which are comparable to the real estate collateral, were recently completed in the area, increasing vacancy rates, decreasing lease rates, and attracting several tenants away from the borrower. Accordingly, credit review personnel at Registrant C adjust certain of the valuation assumptions to better reflect the current market conditions as they relate to the loan's collateral.⁷ After adjusting the collateral valuation assumptions, the credit review department determines that the current estimated fair value of the collateral, less costs to sell, is \$8 million.⁸ Given that the recorded investment in the loan is \$10 million, Registrant C concludes that the loan is impaired by \$2 million and records an allowance for loan losses of \$2 million.

Question: What documentation would the staff normally expect Registrant C to maintain to support its determination of the allowance for loan losses of \$2 million for the loan to Company X?

Interpretive Response: The staff normally would expect Registrant C to document that it measured impairment of the loan to Company X by using the fair value of the loan's collateral, less costs to sell, which it estimated to be \$8 million.⁹ This documentation¹⁰ should include the registrant's rationale and basis for the \$8 million valuation, including the revised valuation assumptions it used, the valuation calculation, and the determination of costs to sell, if applicable.

Because Registrant C arrived at the valuation of \$8 million by modifying an earlier appraisal, it should document its

¹ Paragraph 8 of Statement 114 provides that a loan is impaired when, based on current information and events, it is probable that all amounts due will not be collected pursuant to the terms of the loan agreement.

² See paragraph 13 of Statement 114.

³ Under GAAS, auditors should obtain "sufficient competent evidential matter" to support its audit opinion. See AU Section 326. The staff normally would expect registrants to maintain such evidential matter for its allowances for loan losses for use by the auditors in conducting their annual audit.

⁴ Paragraph 7.45 in the Audit Guide outlines sources of information, available from management, that the independent accountant should consider in identifying loans that contain high credit risk or other significant exposures and concentrations. These sources of information would also likely include documentation of loan impairment under Statement 114 or Statement 5. Additionally, as indicated in paragraphs 7.56 to 7.68 of the Audit Guide, the independent accountant, in conducting an audit, may perform a detailed loan file review for selected loans. A registrant's loan files may contain documentation about borrowers' financial resources and cash flows (see paragraph 7.63) or about the collateral securing the loans, if applicable (see paragraph 7.65 and 7.66).

⁵ Question #16 in Exhibit D-80A of EITF Topic D-80 indicates that environmental factors include existing industry, geographical, economic, and political factors.

⁶ See paragraphs 7.65 and 7.66 in the Audit Guide for additional information about documentation of loan collateral.

⁷ When reviewing collateral dependent loans, Registrant C may often find it more appropriate to obtain an updated appraisal to estimate the effect of current market conditions on the appraised value instead of internally estimating an adjustment.

⁸ An auditor who uses the work of a specialist, such as an appraiser, in performing an audit in accordance with GAAS should refer to the guidance in SAS 73 (AU Section 336).

⁹ See paragraphs 7.65 to 7.66 in the Audit Guide for further information about documentation of loan collateral and associated audit procedures that may be performed by the independent accountant.

¹⁰ As stated in paragraph 7.14 of the Audit Guide, "[t]he institution's conclusions about the appropriate amount [of loan impairment and the allowance for loan losses] should be well documented."

rationale and basis for the changes it made to the valuation assumptions that resulted in the collateral value declining from \$12 million eighteen months ago to \$8 million in the current period.

c. Measuring and Documenting Loan Losses Under Statement 114—Fully Collateralized Loans

Question: In the staff's view, what is an example of an acceptable documentation practice for a registrant to adequately support its determination that no allowance for loan losses should be recorded for a group of loans because the loans are fully collateralized?

Interpretive Response: Consider the following fact pattern: Registrant D has \$10 million in loans that are fully collateralized by highly rated debt securities with readily determinable market values. The loan agreement for each of these loans requires the borrower to provide qualifying collateral sufficient to maintain a loan-to-value ratio with sufficient margin to absorb volatility in the securities' market prices. Registrant D's collateral department has physical control of the debt securities through safekeeping arrangements. In addition, Registrant D perfected its security interest in the collateral when the funds were originally distributed. On a quarterly basis, Registrant D's credit administration function determines the market value of the collateral for each loan using two independent market quotes and compares the collateral value to the loan carrying value. If there are any collateral deficiencies, Registrant D notifies the borrower and requests that the borrower immediately remedy the deficiency. Due in part to its efficient operation, Registrant D has historically not incurred any material losses on these loans. Registrant D believes these loans are fully-collateralized and therefore does not maintain any loan loss allowance balance for these loans.

Registrant D's management summary of the loan loss allowance includes documentation indicating that, in accordance with its loan loss allowance policy, the collateral protection on these loans has been verified by the registrant, no probable loss has been incurred, and no loan loss allowance is necessary.

Documentation in Registrant D's loan files includes the two independent market quotes obtained each quarter for each loan's collateral amount, the documents evidencing the perfection of the security interest in the collateral, and other relevant supporting documents. Additionally, Registrant D's loan loss allowance policy includes a discussion of how to determine when a

loan is considered "fully collateralized" and does not require a loan loss allowance. Registrant D's policy requires the following factors to be considered and its findings concerning these factors to be fully documented:

- Volatility of the market value of the collateral;
- Recency and reliability of the appraisal or other valuation;
- Recency of the registrant's or third party's inspection of the collateral;
- Historical losses on similar loans;
- Confidence in the registrant's lien or security position including appropriate:
 - Type of security perfection (e.g., physical possession of collateral or secured filing);
 - Filing of security perfection (i.e., correct documents and with the appropriate officials); and
 - Relationship to other liens; and
 - Other factors as appropriate for the loan type.

In the staff's view, Registrant D's documentation supporting its determination that certain of its loans are fully collateralized, and no loan loss allowance should be recorded for those loans, is acceptable under FRR 28.

4. Applying a Systematic Methodology—Measuring and Documenting Loan Losses Under Statement 5

a. Measuring and Documenting Loan Losses Under Statement 5—General

Question 1: In the staff's view, what are some general considerations for a registrant in applying its systematic methodology to measure and document loan losses under Statement 5?

Interpretive Response: For loans evaluated on a group basis under Statement 5, the staff believes that a registrant should segment the loan portfolio by identifying risk characteristics that are common to groups of loans.¹ Registrants typically decide how to segment their loan portfolios based on many factors, which vary with their business strategies as well as their information system capabilities. Regardless of the segmentation method used, the staff normally would expect a registrant to maintain documentation to support its conclusion that the loans in each segment have similar attributes or characteristics. As economic and other business conditions change, registrants often modify their business strategies,

which may result in adjustments to the way in which they segment their loan portfolio for purposes of estimating loan losses. The staff normally would expect registrants to maintain documentation to support these segmentation adjustments.²

Based on the segmentation of the loan portfolio, a registrant should estimate the Statement 5 portion of its loan loss allowance. For those segments that require an allowance for loan losses,³ the registrant should estimate the loan losses, on at least a quarterly basis, based upon its ongoing loan review process and analysis of loan performance.⁴ The registrant should follow a systematic and consistently applied approach to select the most appropriate loss measurement methods and support its conclusions and rationale with written documentation.⁵

Facts: After identifying certain loans for evaluation under Statement 114, Registrant E segments its remaining loan portfolio into five pools of loans. For three of the pools, it measures loan impairment under Statement 5 by applying historical loss rates, adjusted for relevant environmental factors, to the pools' aggregate loan balances. For the remaining two pools of loans, Registrant E uses a loss estimation model that is consistent with GAAP to measure loan impairment under Statement 5.

Question 2: What documentation would the staff normally expect Registrant E to prepare to support its loan loss allowance for its pools of loans under Statement 5?

Interpretive Response: Regardless of the method used to determine loan loss measurements under Statement 5, Registrant E should demonstrate and document that the loss measurement

² Segmentation of the loan portfolio is a standard element in a loan loss allowance methodology. As indicated in paragraph 7.05 of the Audit Guide, the loan loss allowance methodology "should be well documented, with clear explanations of the supporting analyses and rationale."

³ An example of a loan segment that does not generally require an allowance for loan losses is a group of loans that are fully secured by deposits maintained at the lending institution.

⁴ FRR 28 refers to a "systematic methodology to be employed each period" in determining provisions and allowances for loan losses. As indicated in FRR 28, the staff normally would expect that the systematic methodology would be documented "to help ensure that all matters affecting loan collectibility will consistently be identified in the detailed [loan] review process."

⁵ *Ibid.* Also, as indicated in paragraph 7.05 of the Audit Guide, the loan loss allowance methodology "should be well documented, with clear explanations of the supporting analyses and rationale." Further, as indicated in paragraph 7.14 of the Audit Guide, "[t]he institution's conclusions about the appropriate amount [of the allowance] should be well documented."

¹ Paragraph 7.07 of the Audit Guide indicates that "[e]ach segment [of the loan portfolio] should contain loans with similar characteristics, such as risk classification, past-due status, and type of loan."

methods used to estimate the loan loss allowance for each segment of its loan portfolio are determined in accordance with GAAP as of the financial statement date.⁶

As indicated for Registrant E, one method of estimating loan losses for groups of loans is through the application of loss rates to the groups' aggregate loan balances. Such loss rates typically reflect the registrant's historical loan loss experience for each group of loans, adjusted for relevant environmental factors (e.g., industry, geographical, economic, and political factors) over a defined period of time. If a registrant does not have loss experience of its own, it may be appropriate to reference the loss experience of other companies in the same business, provided that the registrant demonstrates that the attributes of the loans in its portfolio segment are similar to those of the loans included in the portfolio of the registrant providing the loss experience.⁷ Registrants should maintain supporting documentation for the technique used to develop their loss rates, including the period of time over which the losses were incurred. If a range of loss is determined, registrants should maintain documentation to support the identified range and the rationale used for determining which estimate is the best estimate within the range of loan losses.⁸

The staff normally would expect that, before employing a loss estimation model, a registrant would evaluate and modify, as needed, the model's assumptions to ensure that the resulting loss estimate is consistent with GAAP. In order to demonstrate consistency with GAAP, registrants that use loss estimation models should typically document the evaluation, the conclusions regarding the appropriateness of estimating loan losses with a model or other loss estimation tool, and the objective

support for adjustments to the model or its results.⁹

In developing loss measurements, registrants should consider the impact of current environmental factors and then document which factors were used in the analysis and how those factors affected the loss measurements. Factors that should be considered in developing loss measurements include the following:¹⁰

- Levels of and trends in delinquencies and impaired loans;
- Levels of and trends in charge-offs and recoveries;
- Trends in volume and terms of loans;
- Effects of any changes in risk selection and underwriting standards, and other changes in lending policies, procedures, and practices;
- Experience, ability, and depth of lending management and other relevant staff;
- National and local economic trends and conditions;
- Industry conditions; and
- Effects of changes in credit concentrations.

For any adjustment of loss measurements for environmental factors, a registrant should maintain sufficient, objective evidence¹¹ (a) to support the amount of the adjustment and (b) to explain why the adjustment is necessary to reflect current information, events, circumstances, and conditions in the loss measurements.

b. Measuring and Documenting Loan Losses Under Statement 5—Adjusting Loss Rates

Facts: Registrant F's lending area includes a metropolitan area that is financially dependent upon the profitability of a number of manufacturing businesses. These businesses use highly specialized equipment and significant quantities of rare metals in the manufacturing process. Due to increased low-cost foreign competition, several of the parts suppliers servicing these manufacturing firms declared bankruptcy. The foreign suppliers have subsequently increased prices and the manufacturing firms have suffered from increased equipment maintenance costs and smaller profit margins.

⁹ The systematic methodology (including, if applicable, loss estimation models) used to determine loan loss provisions and allowances should be documented in accordance with FRR 28, paragraph 7.05 of the Audit Guide, and EITF Topic D-80.

¹⁰ Refer to paragraph 7.13 in the Audit Guide.

¹¹ AU 326 describes the "sufficient competent evidential matter" that auditors must consider in accordance with GAAS.

Additionally, the cost of the rare metals used in the manufacturing process increased and has now stabilized at double last year's price. Due to these events, the manufacturing businesses are experiencing financial difficulties and have recently announced downsizing plans.

Although Registrant F has yet to confirm an increase in its loss experience as a result of these events, management knows that it leads to a significant number of businesses and individuals whose repayment ability depends upon the long-term viability of the manufacturing businesses. Registrant F's management has identified particular segments of its commercial and consumer customer bases that include borrowers highly dependent upon sales or salary from the manufacturing businesses. Registrant F's management performs an analysis of the affected portfolio segments to adjust its historical loss rates used to determine the loan loss allowance. In this particular case, Registrant F has experienced similar business and lending conditions in the past that it can compare to current conditions.

Question: How would the staff normally expect Registrant F to document its support for the loss rate adjustments that result from considering these manufacturing firms' financial downturns?¹²

Interpretive Response: The staff normally would expect Registrant F to document its identification of the particular segments of its commercial and consumer loan portfolio for which it is probable that the manufacturing business' financial downturn has resulted in loan losses. In addition, the staff normally would expect Registrant F to document its analysis that resulted in the adjustments to the loss rates for the affected portfolio segments.¹³ The staff normally would expect that, as part of its documentation, Registrant F would maintain copies of the documents supporting the analysis, which may include relevant economic reports,

¹² This question and response would also apply to other registrant fact patterns in which the registrant adjusts loss rates for environmental factors.

¹³ Paragraph 7.33 of the Audit Guide refers to the documentation, for disclosure purposes, that an entity should include in the notes to the financial statements describing the accounting policies and methodology the entity used to estimate its allowance and related provision for loan losses. As indicated in paragraph 7.33, "[s]uch a description should identify the factors that influenced management's judgment (for example, historical losses and existing economic conditions) and may also include discussion of risk elements relevant to particular categories of financial instruments."

⁶ Refer to paragraph 8(b) of Statement 5. Also, as indicated in Exhibit D-80A of EITF Topic D-80, "[t]he approach for determination of the allowance should be well documented and applied consistently from period to period." (See the overview section of Exhibit D-80A and Question #18.)

⁷ Refer to paragraph 23 of Statement 5.

⁸ Registrants should also refer to Interpretation 14, which provides guidance for situations in which a range of loss can be reasonably estimated but no single amount within the range appears to be a better estimate than any other amount within the range. Also, paragraph 7.14 of the Audit Guide notes that the use of "a method that results in a range of estimates for the allowance," except for impairment measurement under Statement 114, which is based on "a single best estimate and not a range of estimates." Paragraph 7.14 also states that "[t]he institution's conclusions about the appropriate amount should be well documented."

economic data, and information from individual borrowers.

Because in this case Registrant F has experienced similar business and lending conditions in the past, it should consider including in its supporting documentation an analysis of how the current conditions compare to its previous loss experiences in similar circumstances. The staff normally would expect that, as part of Registrant F's effective loan loss allowance methodology, it would create a summary of the amount and rationale for the adjustment factor for review by management prior to the issuance of the financial statements.¹⁴

c. Measuring and Documenting Loan Losses Under Statement 5—Estimating Losses on Loans Individually Reviewed for Impairment but not Considered Individually Impaired

Facts: Registrant G has outstanding loans of \$2 million to Company Y and \$1 million to Company Z, both of which are paying as agreed upon in the loan documents. The registrant's loan loss allowance policy specifies that all loans greater than \$750,000 must be individually reviewed for impairment under Statement 114. Company Y's financial statements reflect a strong net worth, good profits, and ongoing ability to meet debt service requirements. In contrast, recent information indicates Company Z's profitability is declining and its cash flow is tight. Accordingly, this loan is rated substandard under the registrant's loan grading system. Despite its concern, management believes Company Z will resolve its problems and determines that neither loan is individually impaired as defined by Statement 114.

Registrant G segments its loan portfolio to estimate loan losses under Statement 5. Two of its loan portfolio segments are Segment 1 and Segment 2. The loan to Company Y has risk characteristics similar to the loans included in Segment 1 and the loan to Company Z has risk characteristics similar to the loans included in Segment 2.¹⁵

In its determination of its loan loss allowance under Statement 5, Registrant G includes its loans to Company Y and Company Z in the groups of loans with similar characteristics (*i.e.*, Segment 1

for Company Y's loan and Segment 2 for Company Z's loan).¹⁶ Management's analyses of Segment 1 and Segment 2 indicate that it is probable that each segment includes some losses, even though the losses cannot be identified to one or more specific loans. Management estimates that the use of its historical loss rates for these two segments, with adjustments for changes in environmental factors, provides a reasonable estimate of the registrant's probable loan losses in these segments.

Question: How would the staff normally expect Registrant G to adequately document a loan loss allowance under Statement 5 for these loans that were individually reviewed for impairment but are not considered individually impaired?

Interpretive Response: The staff normally would expect that, as part of Registrant G's effective loan loss allowance methodology, it would document its decision to include its loans to Company Y and Company Z in its determination of its loan loss allowance under Statement 5.¹⁷ The staff also normally would expect that Registrant G would document the specific characteristics of the loans that were the basis for grouping these loans with other loans in Segment 1 and Segment 2, respectively.¹⁸ Additionally, the staff normally would expect Registrant G to maintain documentation to support its method of estimating loan losses for Segment 1 and Segment 2, which typically would include the average loss rate used, the analysis of historical losses by loan type and by internal risk rating, and support for any adjustments to its historical loss rates.¹⁹ The registrant would typically maintain copies of the economic and other reports that provided source data.

When measuring and documenting loan losses, Registrant G should take

¹⁶ Question #10 in Exhibit D-80A of EITF Topic D-80 states that if a creditor concludes that an individual loan specifically identified for evaluation is not impaired under Statement 114, that loan may be included in the assessment of the allowance for loan losses under Statement 5, but only if specific characteristics of the loan indicate that it is probable that there would be an incurred loss in a group of loans with those characteristics.

¹⁷ Paragraph 7.05 in the Audit Guide indicates that an entity's method of estimating credit losses should "include a detailed and regular analysis of the loan portfolio," "consider all loans (whether on an individual or pool-of-loans basis)," "be based on current and reliable data," and "be well documented, with clear explanations of the supporting analyses and rationale." Question #10 in Exhibit D-80A of EITF Topic D-80 provides guidance as to the analysis to be performed when determining whether a loan that is not individually impaired under Statement 114 should be included in the assessment of the loan loss allowance under Statement 5.

¹⁸ *Ibid.*

¹⁹ *Ibid.*

steps to prevent layering loan loss allowances. Layering is the inappropriate practice of recording in the allowance more than one amount for the same probable loan loss. Layering can happen when a registrant includes a loan in one segment, determines its best estimate of loss for that loan either individually or on a group basis (after taking into account all appropriate environmental factors, conditions, and events), and then includes the loan in another group, which receives an additional loan loss allowance amount.

5. Documenting the Results of a Systematic Methodology

a. Documenting the Results of a Systematic Methodology—General

Facts: Registrant H has completed its estimation of its loan loss allowance for the current reporting period, in accordance with GAAP, using its established systematic methodology.

Question: What summary documentation would the staff normally expect Registrant H to prepare to support the amount of its loan loss allowance to be reported in its financial statements?

Interpretive Response: The staff normally would expect that, to verify that loan loss allowance balances are presented fairly in accordance with GAAP and are auditable, management would prepare a document that summarizes the amount to be reported in the financial statements for the loan loss allowance.¹ Common elements that the staff normally would expect to find documented in loan loss allowance summaries include:²

- The estimate of the probable loss or range of loss incurred for each category evaluated (*e.g.*, individually evaluated impaired loans, homogeneous pools, and other groups of loans that are collectively evaluated for impairment);
- The aggregate probable loss estimated using the registrant's methodology;
- A summary of the current loan loss allowance balance;
- The amount, if any, by which the loan loss allowance balance is to be adjusted;³ and

¹ FRR 28 states: "[t]he specific rationale upon which the [loan loss allowance and provision] amount actually reported is based—*i.e.*, the bridge between the bridge between the findings of the detailed review [of the loan portfolio] and the amount actually reported in each period—would be documented to help ensure the adequacy of the reported amount, to improve auditability, and to serve as a benchmark for exercise of prudent judgment in future periods."

² See also paragraph 7.14 of the Audit guide.

³ Subsequent to adjustments, the staff normally would expect that there would be no material differences between the consolidated loss estimate,

¹⁴ Paragraph 7.39 in the Audit Guide indicates that effective internal control related to the allowance for loan losses should include "accumulation of relevant, sufficient, and reliable data on which to base management's estimate of the allowance."

¹⁵ These groups of loans do not include any loans that have been individually reviewed for impairment under Statement 114 and determined to be impaired as defined by Statement 114.

- Depending on the level of detail that supports the loan loss allowance analysis, detailed subschedules of loss estimates that reconcile to the summary schedule.

Generally, a registrant's review and approval process for the loan loss allowance relies upon the data provided in these consolidated summaries. There may be instances in which individuals or committees that review the loan loss allowance methodology and resulting allowance balance identify adjustments that need to be made to the loss estimates to provide a better estimate of loan losses. These changes may be due to information not known at the time of the initial loss estimate (e.g., information that surfaces after determining and adjusting, as necessary, historical loss rates, or a recent decline in the marketability of property after conducting a Statement 114 valuation based upon the fair value of collateral). It is important that these adjustments are consistent with GAAP and are reviewed and approved by appropriate personnel.⁴ Additionally, it would typically be appropriate for the summary to provide each subsequent reviewer with an understanding of the support behind these adjustments. Therefore, the staff normally would expect management to document the nature of any adjustments and the underlying rationale for making the changes.⁵

The staff also normally would expect this documentation to be provided to those among management making the final determination of the loan loss allowance amount.⁶

b. Documenting the Results of a Systematic Methodology—Allowance Adjustments

Facts: Registrant I determines its loan loss allowance using an established systematic process. At the end of each reporting period, the accounting department prepares a summary schedule that includes the amount of each of the components of the loan loss

allowance, as well as the total loan loss allowance amount, for review by senior management, including the Credit Committee. Members of senior management meet to discuss the loan loss allowance. During these discussions, they identify changes that are required by GAAP to be made to certain of the loan loss allowance estimates. As a result of the adjustments made by senior management, the total amount of the loan loss allowance changes. However, senior management (or its designee) does not update the loan loss allowance summary schedule to reflect the adjustments or reasons for the adjustments. When performing their audit of the financial statements, the independent accountants are provided with the original loan loss allowance summary schedule reviewed by senior management, as well as a verbal explanation of the changes made by senior management when they met to discuss the loan loss allowance.

Question: In the staff's view, are Registrant I's documentation practices related to the balance of its loan loss allowance in compliance with existing documentation guidance in this area?

Interpretive Response: No. A registrant should maintain supporting documentation for the loan loss allowance amount reported in its financial statements.⁷ As illustrated above, there may be instances in which loan loss allowance reviewers identify adjustments that need to be made to the loan loss estimates. The staff normally would expect the nature of the adjustments, how they were measured or determined, and the underlying rationale for making the changes to the loan loss allowance balance to be documented.⁸ The staff also normally would expect appropriate documentation of the adjustments to be provided to management for review of the final loan loss allowance amount to be reported in the financial statements. This documentation should also be made available to the independent accountants. If changes frequently occur during management or credit committee reviews of the loan loss allowance, management may find it appropriate to analyze the reasons for the frequent changes and to reassess the methodology the registrant uses.⁹

⁷ *Ibid.*

⁸ *Ibid.*

⁹ As outlined in paragraph 7.39 of the Audit Guide, effective internal controls related to the allowance for loan losses should include adequate review and approval of allowance estimates, including review of sources of relevant information, review of development of assumptions, review of reasonableness of assumptions and resulting estimates, and consideration of changes in

6. Validating a Systematic Methodology

Question: What is the staff's guidance to a registrant on validating, and documenting the validation of, its systematic methodology used to estimate loan loss allowances?

Interpretive Response: The staff believes that a registrant's loan loss allowance methodology is considered valid when it accurately estimates the amount of loss contained in the portfolio. Thus, the staff normally would expect the registrant's methodology to include procedures that adjust loan loss estimation methods to reduce differences between estimated losses and actual subsequent charge-offs, as necessary. To verify that the loan loss allowance methodology is valid and conforms to GAAP, the staff believes it is appropriate for management to establish internal control policies,¹ appropriate for the size of the registrant and the type and complexity of its loan products.

These policies may include procedures for a review, by a party who is independent of the allowance for loan losses estimation process, of the allowance for loan losses methodology and its application in order to confirm its effectiveness.

In practice, registrants employ numerous procedures when validating the reasonableness of their loan loss allowance methodology and determining whether there may be deficiencies in their overall methodology or loan grading process. Examples are:

- A review of trends in loan volume, delinquencies, restructurings, and concentrations.
- A review of previous charge-off and recovery history, including an evaluation of the timeliness of the entries to record both the charge-offs and the recoveries.
- A review by a party that is independent of the loan loss allowance estimation process. This often involves the independent party reviewing, on a test basis, source documents and underlying assumptions to determine that the established methodology develops reasonable loss estimates.
- An evaluation of the appraisal process of the underlying collateral. This may be accomplished by periodically comparing the appraised value to the actual sales price on selected properties sold.

It is the staff's understanding that, in practice, management usually supports the validation process with the

previously established methods to arrive at the allowance.

¹ *Ibid.*

as determined by the methodology, and the final loan loss allowance balance reported in the financial statements. Registrants should refer to SAB 99 and SAS 89 and its amendments to AU Section 310.

⁴ Paragraph 7.39 in the Audit guide indicates that effective internal control related to the allowance for loan losses should include "adequate review and approval of the allowance estimates by the individuals specified in management's written policy."

⁵ See the guidance in paragraph 7.14 of the Audit Guide ("the institution's conclusions about the appropriate amount should be well documented") and in FRR 28 ("the specific rationale upon which the amount actually reported in each individual period is based would be documented").

⁶ *Ibid.*

workpapers from the loan loss allowance review function. Additional documentation often includes the summary findings of the independent reviewer. The staff normally would expect that, if the methodology is changed based upon the findings of the validation process, documentation that describes and supports the changes would be maintained.²

Topic 7: Real Estate Companies

A. Deleted by SAB 103

B. Deleted by SAB 103

C. Schedules of Real Estate and Accumulated Depreciation, and of Mortgage Loans on Real Estate

Facts: Whenever investments in real estate or mortgage loans on real estate are significant, the schedules of such items (see Rules 12-28 and 12-29 of Regulation S-X) are required in a prospectus.

Question: Is such information also required in annual reports to shareholders?

Interpretive Response: Although Rules 14a-3 and 14c-3 permit the omission of financial statement schedules from annual reports to shareholders, the staff is of the view that the information required by these schedules is of such significance within the real estate industry that the information should be included in the financial statements in the annual report to shareholders.

D. Income Before Depreciation

Facts: Occasionally an income statement format will contain a subtitle or caption titled "Income before depreciation and depletion."

Question: Is this caption appropriate?

Interpretive Response: The staff objects to this presentation because in the staff's view the presentation may suggest to the reader that the amount so captioned represents cash flow for the period, which is rarely the case (see ASR 142).

Topic 8: Retail Companies

A. Sales of Leased or Licensed Departments

Facts: At times, department stores and other retailers have included the sales of leased or licensed departments in the amount reported as "total revenues."

Question: Does the staff have any objection to this practice?

Interpretive Response: In November 1975 the staff issued SAB 1 that addressed this issue. In that SAB the staff did not object to retailers presenting sales of leased or licensed departments in the amount reported as "total revenues" because of industry practice. Subsequently, in November 1976 the FASB issued Statement 13. In June 1995, the AICPA staff amended its Technical Practice Aid (TPA) section 5100.16 based upon an interpretation of Statement 13 that leases of departments within a retail establishment are leases of tangible assets within the scope of Statement 13.¹ Consistent with the interpretation in TPA section 5100.16, the staff believes that Statement 13 requires department stores and other retailers that lease or license store space to account for rental income from leased departments in accordance with Statement 13. Accordingly, it would be inappropriate for a department store or other retailer to include in its revenue the sales of the leased or licensed departments. Rather, the department store or other retailer should include the rental income as part of its gross revenue. The staff would not object to disclosure in the footnotes to the financial statements of the amount of the lessee's sales from leased departments. If the arrangement is not a lease but rather a service arrangement that provides for payment of a fee or commission, the retailer should recognize the fee or commission as revenue when earned. If the retailer assumes the risk of bad debts associated with the lessee's merchandise sales, the

retailer generally should present bad debt expense in accordance with Rule 5-03(b)(5) of Regulation S-X.

B. Finance Charges

Facts: Department stores and other retailers impose finance charges on credit sales.

Question: How should such charges be disclosed?

Interpretive Response: As a minimum, the staff requests that the amount of gross revenue from such charges be stated in a footnote and that the income statement classification which includes such revenue be identified. The following are examples of acceptable disclosure:

Example 1

Consumer Credit Operations:

The results of the Consumer Credit Operations which are included in the Statement of Earnings as a separate line item are as follows for the fiscal year ended January 31, 20x0:

Service charges	\$167,000,000
Operating expenses	
Interest	60,000,000
Payroll	35,000,000
Provision for uncollected accounts	29,000,000
All other credit and collection expenses	32,000,000
Provision for Federal income taxes	5,000,000
Total operating expenses	161,000,000
Consumer credit operations earnings	6,000,000

Example 2

Service charges on retail credit accounts are netted against selling, general and administrative expense. The cost of administering retail credit program continued to exceed service charges on customer receivables as follows:

(in millions)	20x2	20x1	Percent increase (decrease)
Costs:			
Regional office operations	\$45	\$42	9
Interest	51	44	13
Provision for doubtful accounts	21	15	34
Total	\$117	\$102	15
Less service charge income	96	79	22
Net cost of credit	\$21	\$23	(10)

² See paragraph 7.39 of the Audit Guide.

¹ Statement 13, paragraph 1 defines a lease as "the right to use property, plant, or equipment (land

or depreciable assets or both) usually for a stated period of time."

(in millions)	20x2	20x1	Percent increase (decrease)
Net cost as percent of credit sales	1.4%	1.6%	

The above results do not reflect either “in store” costs related to credit operations or any allocation of corporate overhead expenses.

This SAB is not intended to change current guidance in the accounting literature. For this reason, adherence to the principles described in this SAB should not raise the costs associated with record-keeping or with audits of financial statements.

Topic 9: Finance Companies

A. Deleted by SAB 103

B. Deleted by ASR 307

Topic 10: Utility Companies

A. Financing by Electric Utility Companies Through Use of Construction Intermediaries

Facts: Some electric utility companies finance construction of a generating plant or their share of a jointly owned plant through the use of a “construction intermediary” which may be organized as a trust or a corporation. Typically the utility assigns its interest in property and other contract rights to the construction intermediary with the latter authorized to obtain funds to finance construction with term loans, bank loans, commercial paper and other sources of funds and that may be available. The intermediary’s borrowings are guaranteed in part of the work in progress but more significantly, although indirectly, by the obligation of the utility to purchase the project upon completion and assume or otherwise settle the borrowings. The utility may be committed to provide any deficiency of funds which the intermediary cannot obtain and excess funds may be loaned to the utility by the intermediary. (In one case involving construction of an entire generating plant, the intermediary appointed the utility as its agent to complete construction.) On the occurrence of an event such as commencement of the testing period for the plant or placing the plant in commercial service (but not later than a specified date) the interest in the plant reverts to the utility and concurrently the utility must either assume the obligations issued by the intermediary or purchase them from the holders. The intermediary also may be authorized to borrow amounts for accrued interest when due and those amounts are added to the balance of the outstanding

indebtedness. Interest is thus capitalized during the construction period at rates being charged by the lenders; however, it is deductible by the utility for tax purposes in the year of accrual.

Question: How should construction work in progress and related liabilities and interest expense being financed through a construction intermediary be reflected in an electric utility’s financial statements?

Interpretive Response: The balance sheet of an electric utility company using a construction intermediary to finance construction should include the intermediary’s work in progress in the appropriate caption under utility plant. The related debt should be included in long-term liabilities and disclosed either on the balance sheet or in a note.

The amount of interest cost incurred and the respective amounts expensed or capitalized shall be disclosed for each period for which an income statement is presented. Consequently, capitalized interest included as part of an intermediary’s construction work in progress on the balance sheet should be recognized on the current income statement as interest expense with a corresponding offset to allowance for borrowed funds used during construction. Income statements for prior periods should also be restated. The amounts may be shown separately on the statement or included with interest expense and allowance for borrowed funds used during construction.

A note to the financial statements should describe briefly the organization and purpose of the intermediary and the nature of its authorization to incur debt to finance construction. The note should disclose the rate at which interest on this debt has been capitalized and the dollar amount for each period for which an income statement is presented.

B. Deleted by SAB 103

C. Jointly Owned Electric Utility Plants

Facts: Groups of electric utility companies have been building and operating utility plants under joint ownership agreements or arrangements which do not create legal entities for which separate financial statements are presented.¹ Under these arrangements, a

participating utility has an undivided interest in a utility plant and is responsible for its proportionate share of the costs of construction and operation and its entitled to its proportionate share of the energy produced.

During the construction period a participating utility finances its own share of a utility plant using its own financial resources and not the combined resources of the group. Allowance for funds used during construction is provided in the same manner and at the same rates as for plants constructed to be used entirely by the participant utility.

When a joint-owned plant becomes operational, one of the participant utilities acts as operator and bills the other participants for their proportionate share of the direct expenses incurred. Each individual participant incurs other expenses related to transmission, distribution, supervision and control which cannot be related to the energy generated or received from any particular source. Many companies maintain depreciation records on a composite basis for each class of property so that neither the accumulated allowance for depreciation nor the periodic expense can be allocated to specific generating units whether jointly or wholly owned.

Question: What disclosure should be made on the financial statements or in the notes concerning interests in jointly owned utility plants?

Interpretive Response: A participating utility should include information concerning the extent of its interests in jointly owned plants in a note to its financial statements. The note should include a table showing separately for each interest in a jointly owned plant the amount of utility plant in service, the accumulated provision for depreciation (if available), the amount of plant under construction, and the proportionate share. The amounts presented for plant in service or plant under construction may be further subdivided to show amounts applicable to plant subcategories such as production, transmission, and distribution. The note should include statements that the dollar amounts represent the participating utility’s share in each joint plant and that each

¹ Before considering the guidance in this SAB Topic, registrants are reminded that the

arrangement should be evaluated in accordance with the provisions of Interpretation 46.

participant must provide its own financing. Information concerning two or more generating plants on the same site may be combined if appropriate.

The note should state that the participating utility's share of direct expenses of the joint plants is included in the corresponding operating expenses on its income statement (e.g., fuel, maintenance of plant, other operating expense). If the share of direct expenses is charged to purchased power then the note should disclose the amount so charged and the proportionate amounts charged to specific operating expenses on the records maintained for the joint plants.

D. Long-Term Contracts for Purchase of Electric Power

Facts: Under long-term contracts with public utility districts, cooperatives or other organizations, a utility company receives a portion of the output of a production plant constructed and financed by the district or cooperative. The utility has only a nominal or no investment at all in the plant but pays a proportionate part of the plant's costs, including debt service. The contract may be in the form of a sale of a generating plant and its immediate lease back. The utility is obligated to pay certain minimum amounts which cover debt service requirements whether or not the plant is operating. At the option of other parties to the contract and in accordance with a predetermined schedule, the utility's proportionate share of the output may be reduced. Separate agreements may exist for the transmission of power to the utility's system.¹

Question: How should the cost of power obtained under long-term purchase contracts be reflected on the financial statements and what supplemental disclosures should be made in notes to the statements?

Interpretive Response: The cost of power obtained under long-term purchase contracts, including payments required to be made when a production plant is not operating, should be included in the operating expenses section of the income statement. A note to the financial statements should present information concerning the terms and significance of such contracts to the utility company including date of contract expiration, share of plant output being purchased, estimated

annual cost, annual minimum debt service payment required and amount of related long-term debt or lease obligations outstanding.

Additional disclosure should be given if the contract provides, or is expected to provide, in excess of five percent of current or estimated future system capability. This additional disclosure may be in the form of separate financial statements of the vendor entity or inclusion of the amount of the obligation under the contract as a liability on the balance sheet with a corresponding amount as an asset representing the right to purchase power under the contract.

The note to the financial statements should disclose the allocable portion of interest included in charges under such contracts.

E. Classification of Charges for Abandonments and Disallowances

Facts: A public utility company abandons the construction of a plant and, under the provisions of Statement 90, must charge a portion of the costs of the abandoned plant to expense.¹ Also, the utility determines that it is probable that certain costs of a recently completed plant will be disallowed, and charges those costs to expense as required by Statement 90.

Question: May such charges for abandonments and disallowances be reported as extraordinary items in the statement of income?

Interpretive Response: No. The staff does not believe that such charges meet the requirements of APB Opinion 30 that an item be both unusual and infrequent to be classified as an extraordinary item. Accordingly, the public utility was advised by the staff that such charges should be reported as a component of income from continuing operations, separately presented, if material.²

Paragraph 20 of APB Opinion 30 indicates that to be unusual, an item must "possess a high degree of abnormality and be of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of

the entity, taking into account the environment in which the entity operates." Similarly, that paragraph indicates that, to be infrequent, an event should "not reasonably be expected to recur in the foreseeable future."

Electric utilities operate under a franchise that requires them to furnish adequate supplies of electricity for their service area. That undertaking requires utilities to continually forecast the future demand for electricity, and the costs to be incurred in constructing the plants necessary to meet that demand. Abandonments and disallowances result from the failure of demand to reach projected levels and/or plant construction costs that exceed anticipated amounts. Neither event qualifies as being both unusual and infrequent in the environment in which electric utilities operate.

Accordingly, the staff believes that charges for abandonments and disallowances under Statement 90 should not be presented as extraordinary items.³

F. Presentation of Liabilities for Environmental Costs

Facts: A public utility company determines that it is obligated to pay material amounts as a result of an environmental liability. These amounts may relate to, for example, damages attributed to clean-up of hazardous wastes, reclamation costs, fines, and litigation costs.

Question 1: May a rate-regulated enterprise present on its balance sheet the amount of its estimated liability for environmental costs net of probable future revenue resulting from the inclusion of such costs in allowable costs for rate-making purposes?

Interpretive Response: No. Statement 71 specifies the conditions under which rate actions of a regulator can provide reasonable assurance of the existence of an asset. The staff believes that environmental costs meeting the criteria of paragraph 9¹ of Statement 71 should be presented on the balance sheet as an asset and should not be offset against the liability. Contingent recoveries

¹ Paragraph 3 of Statement 90 requires that costs of abandoned plants in excess of the present value of the future revenues expected to be provided to recover any allowable costs be charged to expense in the period that the abandonment becomes probable. Also, paragraph 7 of Statement 90 requires that disallowed costs for recently completed plants be charged to expense when the disallowance becomes probable and can be reasonably estimated.

² Additionally, the registrant was reminded that paragraph 26 of APB Opinion 30 provides that items which are not reported as extraordinary should not be reported on the income statement net of income taxes or in any manner that implies that they are similar to extraordinary items.

³ The staff also notes that paragraphs 3 and 7 of Statement 90, in requiring that such costs be "recognized as a loss," do not specify extraordinary item treatment. The staff believes that it generally has been the FASB's practice to affirmatively require extraordinary item treatment when it believes that it is appropriate for charges or credits to income specifically required by a provision of a statement.

¹ Paragraph 9 of Statement 71 requires a rate-regulated enterprise to capitalize all or part of an incurred cost that would otherwise be charged to expense if it is probable that future revenue will be provided to recover the previously incurred cost from inclusion of the costs in allowable costs for rate-making purposes.

¹ Registrants are reminded that the arrangement may contain a guarantee that is within the scope of Interpretation 45. Further, registrants should consider the guidance of Interpretation 46. Also, registrants would need to consider whether the arrangement contains a derivative that should be accounted for according to Statement 133.

through rates that do not meet the criteria of paragraph 9 should not be recognized either as an asset or as a reduction of the probable liability.

Question 2: May a rate-regulated enterprise delay recognition of a probable and estimable liability for environmental costs which it has incurred at the date of the latest balance sheet until the regulator's deliberations have proceeded to a point enabling management to determine whether this cost is likely to be included in allowable costs for rate-making purposes?

Interpretive Response: No. Statement 5 states that an estimated loss from a loss contingency shall be accrued by a charge to income if it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated.² The staff believes that actions of a regulator can affect whether an incurred cost is capitalized or expensed pursuant to Statement 71, but the regulator's actions cannot affect the timing of the recognition of the liability.

Topic 11: Miscellaneous Disclosure

A. Operating-Differential Subsidies

Facts: Company A has received an operating-differential subsidy pursuant to the Merchant Marine Act of 1936, as amended.

Question: How should such subsidies be displayed in the income statement?

Interpretive Response: Revenue representing an operating-differential subsidy under the Merchant Marine Act of 1936, as amended, must be set forth as a separate line item in the income statement either under a revenue caption or as credit in the costs and expenses section.

B. Depreciation and Depletion Excluded From Cost of Sales

Facts: Company B excludes depreciation and depletion from cost of sales in its income statement.

Question: How should this exclusion be disclosed?

Interpretive Response: If cost of sales or operating expenses exclude charges for depreciation, depletion and amortization of property, plant and equipment, the description of the line item should read somewhat as follows: "Cost of goods sold (exclusive of items shown separately below)" or "Cost of goods sold (exclusive of depreciation shown separately below)." To avoid placing undue emphasis on "cash flow," depreciation, depletion and amortization should not be positioned in the income statement in a manner

which results in reporting a figure for income before depreciation.

C. Tax Holidays

Facts: Company C conducts business in a foreign jurisdiction which attracts industry by granting a "holiday" from income taxes for a specified period.

Question: Does the staff generally request disclosure of this fact?

Interpretive Response: Yes. In such event, a note must (1) disclose the aggregate dollar and per share effects of the tax holiday and (2) briefly describe the factual circumstances including the date on which the special tax status will terminate.

D. Deleted by SAB 103

E. Chronological Ordering of Data

Question: Does the staff have any preference in what order data are presented (e.g., the most current data displayed first, etc.)?

Interpretive Response: The staff has no preference as to order; however, financial statements and other data presented in tabular form should read consistently from left to right in the same chronological order throughout the filing. Similarly, numerical data included in narrative sections should be consistently ordered.

F. LIFO Liquidations

Facts: Registrant on LIFO basis of accounting liquidates a substantial portion of its LIFO inventory and as a result includes a material amount of income in its income statement which would not have been recorded had the inventory liquidation not taken place.

Question: Is disclosure required of the amount of income realized as a result of the inventory liquidation?

Interpretive Response: Yes. Such disclosure would be required in order to make the financial statements not misleading. Disclosure may be made either in a footnote or parenthetically on the face of the income statement.

G. Tax Equivalent Adjustment in Financial Statements of Bank Holding Companies

Facts: Bank subsidiaries of bank holding companies frequently hold substantial amounts of state and municipal bonds, interest income from which is exempt from Federal income taxes. Because of the tax exemption the stated yield on these securities is lower than the yield on securities with similar risk and maturity characteristics whose interest is subject to Federal tax. In order to make the interest income and resultant yields on tax exempt obligations comparable to those on taxable investments and loans, a "tax

equivalent adjustment" is often added to interest income when presented in analytical tables or charts. When the data presented also includes income taxes, a corresponding amount is added to income tax expense so that there is no effect on net income. Adjustment may also be made for the tax equivalent effect of exemption from state and local taxes.

Question 1: Is the concept of the tax equivalent adjustment appropriate for inclusion in financial statements and related notes?

Interpretive Response: No. The tax equivalent adjustment represents a credit to interest income which is not actually earned and realized and a corresponding charge to taxes (or other expense) which will never be paid. Consequently, it should not be reflected on the income statement or in notes to financial statements included in reports to shareholders or in a report or registration statement filed with the Commission.

Question 2: May amounts representing tax equivalent adjustments be included in the body of a statement of income provided they are designated as not being included in the totals and balances on the statement?

Interpretive Response: No. The tabular format of a statement develops information in an orderly manner which becomes confusing when additional numbers not an integral part of the statement are inserted into it.

Question 3: May revenues on a tax equivalent adjusted basis be included in selected financial data?

Interpretive Response: Revenues may be included in selected financial data on a tax equivalent basis if the respective captions state which amounts are tax equivalent adjusted and if the corresponding unadjusted amounts are also reported in the selected financial data.

Because of differences among registrants in making the tax equivalency computation, a brief note should describe the extent of recognition of exemption from Federal, state and local taxes and the combined marginal or incremental rate used. Where net operating losses exist, the note should indicate the nature of the tax equivalency adjustment made.

Question 4: May information adjusted to a tax equivalent basis be included in management's discussion and analysis of financial condition and results of operations?

Interpretive Response: One of the purposes of MD&A is to enable investors to appraise the extent that earnings have been affected by changes in business activity and accounting principles or

² Registrants also should apply the guidance of SOP 96-1 in determining the appropriate recognition of environmental remediation costs.

methods. Material changes in items of revenue or expense should be analyzed and explained in textual discussion and statistical tables. It may be appropriate to use amounts or to present yields on a tax equivalent basis. If appropriate, the discussion should include a comment on material changes in investment securities positions that affect tax exempt interest income. For example, there might be a comment on a change from investments in tax exempt securities because of the availability of net operating losses to offset taxable income of current and future periods, or a comment on a change in the quality level of the tax exempt investments resulting in increased interest income and risk and a corresponding increase in the tax equivalent adjustment.

Tax equivalent adjusted amounts should be clearly identified and related to the corresponding unadjusted amounts in the financial statements. A descriptive note similar to that suggested to accompany adjusted amounts included in selected financial data should be provided.

H. Disclosures by Bank Holding Companies Regarding Certain Foreign Loans

1. Deposit/Relending Arrangements

Facts: Certain foreign countries experiencing liquidity problems, by agreement with U.S. banks, have instituted arrangements whereby borrowers in the foreign country may remit local currency to the foreign country's central bank, in return for the central bank's assumption of the borrowers' non-local currency obligations to the U.S. banks. The local currency is held on deposit at the central bank, for the account of the U.S. banks, and may be subject to relending to other borrowers in the country. Ultimate repayment of the obligations to the U.S. banks, in the requisite non-local currency, may not be due until a number of years hence.

Question: What disclosures are appropriate regarding deposit/relending arrangements of this general type?

Interpretive Response: The staff emphasizes that it is the responsibility of each registrant to determine the appropriate financial statement treatment and classification of foreign outstandings. The facts and circumstances surrounding deposit/relending arrangements should be carefully analyzed to determine whether the local currency payments to the foreign central bank represent collections of outstandings for financial reporting purposes, and whether such outstandings should be classified as

nonaccrual, past due or restructured loans pursuant to Item III.C.1. of Industry Guide 3, Statistical Disclosure by Bank Holding Companies ("Guide 3").

The staff believes, however, that the impact of deposit/relending arrangements covering significant amounts of outstandings to a foreign country should be disclosed pursuant to Guide 3, Item III.C.3., Instruction (6)(a).¹ The disclosures should include a general description of the arrangements and, if significant, the amounts of interest income recognized for financial reporting purposes which has not been remitted in the requisite non-local currency to the U.S. bank.

2. Accounting and Disclosures by Bank Holding Companies for a "Mexican Debt Exchange" Transaction

Facts: Inquiries have been made of the staff regarding certain accounting and disclosure issues raised by a proposed "Mexican Debt Exchange" transaction which could involve numerous bank holding companies with existing obligations of the United Mexican States ("Mexico") or other Mexican public sector entities (collectively, "Existing Obligations"). The key elements of the Mexican Debt Exchange are as follows:

Mexico will offer for sale bonds ("Bonds"), denominated in U.S. dollars, which will pay interest at a LIBOR-based floating rate and mature in twenty years. Mexico will undertake to list the Bonds on the Luxembourg Stock Exchange. The Bonds will be secured, as to their ultimate principal value only, by non-interest bearing securities of the U.S. Treasury ("Zero Coupon Treasury Securities") which will be purchased by Mexico. The Zero Coupon Treasury Securities will be pledged to holders of the Bonds and held in custody at the Federal Reserve Bank of New York and will have a maturity date and ultimate principal value which match the maturity date and principal value of the Bonds. While the Bonds will have default and acceleration provisions, the holder of a Bond will not be permitted to have access to the collateral prior to the final scheduled maturity date, at which time the proceeds of the collateral will be available to pay the full principal amount of the Bonds. As such, the holder of a Bond ultimately

will be secured as to principal at maturity; however, the interest payments will not be secured. The Bonds will not be subject to future restructurings of Mexico's Existing Obligations, and Mexico has indicated that neither the Bonds nor the Existing Obligations exchanged therefor will be considered part of a base amount with respect to any future requests by Mexico for new money.

The Mexican Debt Exchange will be structured in such a way that potential purchasers of the Bonds will submit bids on a voluntary basis to the auction agent. These bids will specify the face dollar amount of existing restructured commercial bank obligations of Mexico or of other Mexican public sector entities that the potential purchaser is willing to tender and the face dollar amount of Bonds that the purchaser is willing to accept in exchange for the Existing Obligations. Following the auction date, Mexico will determine the face dollar amount of Bonds to be issued and will exchange the Bonds for Existing Obligations taking first the offer of the largest face dollar amount of Existing Obligations per face dollar amount of Bonds, and so on, until all Bonds which Mexico is willing to issue have been subscribed. It is therefore possible that a greater amount of Existing Obligations could be tendered than Mexico is willing to accept.

The lender has appropriately accounted for the transaction as a troubled debt restructuring in accordance with the provisions of Statement 15 as amended by Statement 114.

Question 1: What financial statement and other disclosure issues regarding the Mexican Debt Exchange and the Bonds received should be considered by registrants?

Interpretive Response: The staff believes that disclosure of the nature of the transaction would be necessary, including:

- Carrying value and terms of Existing Obligations exchanged;
- Face value, carrying value, market value and terms of Bonds received;
- The effect of the transaction on the allowance for loan losses and the provision for losses in the current period; and
- Annual interest income on Existing Obligations exchanged and annual interest income on Bonds received.

On an ongoing basis, the staff believes that the terms, carrying value and market value of the Bonds should be

¹ Instruction (6)(a) calls for description of the nature and impact of developments in countries experiencing liquidity problems which are expected to have a material impact on timely repayment of principal or interest. Additionally, Instruction (6)(d)(ii) to Item III.C.3. calls for disclosure of commitments to relend, or to maintain on deposit, arising in connection with certain restructurings of foreign outstanding.

disclosed, if material, due to their unique features.¹

Question 2: What disclosure with respect to the Bonds received would be acceptable under Industry Guide 3?

Interpretive Response: Instruction (4) to Item III.C.3. of Industry Guide 3 states: "The value of any tangible, liquid collateral may also be netted against cross-border outstandings of a country if it is held and realizable by the lender outside of the borrower's country." Given the unique features of the Bonds in that the ultimate repayment of the principal amount (but not interest) at maturity is assured, the staff will not object to either of two presentations. Under the first presentation, the carrying value of the Bonds, including any accrued but unpaid interest, would be included as a "cross-border outstanding" to the extent it exceeds the current fair value of the Zero Coupon Treasury Securities which collateralize the bonds. Alternatively, under the second presentation, the carrying value of the Bond principal would be excluded from Mexican cross-border outstandings provided (a) disclosure is made of the exclusion, (b) for purposes of determining the 1% and .75% of total assets disclosure thresholds of Item III.C.3. of Industry Guide 3, such carrying values are not excluded, and (c) all the Guide 3 disclosures relating to cross-border outstandings continue to be made, as discussed further below.

For registrants that adopt the alternative disclosure approach and whose Mexican cross-border outstandings (excluding the carrying value of the Bond principal) exceed 1% of total assets, appropriate footnote disclosure of the exclusions should be made. Such footnote should indicate the face amount and carrying value of the Bonds excluded, the market value of such Bonds, and the face amount and current fair value of the Zero Coupon Treasury Securities which secure the Bonds.

If the Mexican cross-border outstandings (excluding the carrying value of the Bond principal) are less than 1% of total assets but with the addition of the carrying value of the Bond principal would exceed 1%, the carrying value of the Mexican cross-border outstandings may be excluded from the list of countries whose cross-border outstandings exceed 1% of total assets provided that a footnote discloses the amount of Mexican cross-border outstandings (excluding the carrying

value of the Bond principal) along with the footnote-type disclosure concerning the Bonds discussed in the previous paragraph. This disclosure and any other material disclosure specified by Item III.C.3. of Industry Guide 3 would continue to be made as long as Mexican exposure, including the carrying value of the Bond principal, exceeded 1%.

If the Mexican cross-border outstandings (excluding the carrying value of the Bond principal) are less than .75% of total assets but with the addition of the carrying value of the Mexican Bond principal would exceed .75% but be less than 1%, cross-border outstandings disclosed pursuant to Instruction (7) to Item III.C.3. of Industry Guide 3 may exclude Mexico provided a footnote is added to the aggregate disclosure which discloses the amount of Mexican cross-border outstandings and the fact that they have not been included. The carrying value of the Bond principal may be excluded from the amount of Mexican cross-border outstandings disclosed in the footnote provided the footnote-type disclosure discussed in the second preceding paragraph is also made.

In essence, the alternative discussed herein results in a change only in the method of presenting information, not in the total information required.¹²

The appropriate disclosure would depend on the level of Mexican cross-border outstandings as follows:

A. Assuming that the remaining Mexican cross-border outstandings are in excess of 1% of total assets:

- Mexican cross-border outstandings (which excludes the total amount of the carrying value of Bond principal) would be disclosed in the table presenting all such outstandings in excess of 1%.

- Proposed footnote disclosure—Not included in this amount is \$11 million of Mexican Government Bonds maturing in 2008, with a carrying value of \$11 million [if different from face value]. These Mexican Government Bonds had a market value of \$11 million on [reporting date]. The principal amount of these bonds is fully secured, at maturity, by \$11 million face value of U.S. zero coupon treasury securities that mature on the same date. The current fair value of these U.S. Government securities is \$11 million at [reporting date]. This collateral is pledged to holders of the bonds and

held in custody at the Federal Reserve Bank of New York. The details of the transaction in which these bonds were acquired was reported in the Corporation's Form (8-K, 10-Q or 10-K) for (date). Accrued interest on the bonds, which is not secured, is included in the outstandings reported [amount to be disclosed if material]. Future interest on the bonds remains a cross-border risk.

B. Assuming that remaining Mexican cross-border outstandings are less than 1% of total assets but with the addition of the carrying value of the Mexican Bond principal would exceed 1%:

- There would not be any disclosure included in any cross-border table.

- The total amount of remaining cross-border Mexican outstandings would be disclosed in a footnote to the table. Such footnote would also explain that the Mexican outstandings are excluded from the table.

- Additional footnote disclosure—(same disclosure in A above).

- The disclosure required under this paragraph (plus any other disclosure required by Item III.C.3. of Guide 3) would continue so long as Mexican exposure, including the carrying value of the Mexican Bond principal, exceeded 1%.

C. Assuming that the remaining Mexican cross-border outstandings is less than .75% of total assets but with the addition of the carrying value of the Mexican Bond principal is greater than .75% but less than 1%:

- Mexico would not be included in the list of names of countries required by Instruction 7 to Item III.C.3. of Industry Guide 3 and the amount of Mexican cross-border outstandings would not be included in the aggregate amount of outstandings attributable to all such countries.

- A footnote would be added to this disclosure of aggregate outstandings which discusses the Mexican outstandings and the Mexican Bonds. An example follows:

Not included in the above aggregate outstandings are the Corporation's cross-border outstandings to Mexico which totaled \$11 million at (reporting date). This amount is less than .75% of total assets. (The remaining portion of this footnote is the same disclosure in A above.)

D. Assuming that the total of the Mexican cross-border outstanding plus the carrying value of the Bond principal is less than the .75% of total assets:

- No disclosure would be required.

- However, same disclosure as in A above would be provided if any other aspects of the financial statements are

¹ Registrants also are reminded that if the security received in the exchange constitutes a debt security within the scope of Statement 115, the disclosures required by Statement 115 also would need to be provided.

¹² The following represents proposed disclosure using the alternative method discussed above. Of course, it would be necessary to supplement this disclosure with the additional disclosures regarding foreign outstandings that are called for by Guide 3 (e.g., an analysis of the changes in aggregate outstandings), and the disclosures called for by the Interpretive Responses to Question 1.

materially affected by this transaction (such as the allowance for loan losses).

Changes in aggregate outstandings to certain countries experiencing liquidity problems are required to be presented in tabular form in compliance with Instruction (6)(b) to Item III.C.3. In this table, Existing Obligations exchanged for the Bonds would generally be included in the aggregate cross-border outstandings at the beginning of the period during which the exchange occurred. For registrants using the alternative method, the amount of Existing Obligations which were exchanged would be included as a deduction in the "other changes" caption in the table. In addition, a footnote will be provided to the table as follows:

- Relates primarily to the exchange of unsecured Mexican outstandings for Mexican bonds. The principal amount of these bonds is secured at maturity by \$11 face U.S. Zero Coupon Treasury Securities which mature on the same date and have a current fair value of \$11. Future interest on the bonds remains a cross-border risk.]

I. Reporting of an Allocated Transfer Risk Reserve in Filings Under the Federal Securities Laws

Facts: The Comptroller of the Currency, Board of Governors of the Federal Reserve System and Federal Deposit Insurance Corporation jointly issued final rules, pursuant to the International Lending Supervision Act of 1983, requiring banking institutions to establish special reserves (Allocated Transfer Risk Reserve "ATRR") against the risks presented in certain international assets when the Federal banking agencies determine that such reserves are necessary. The rules provide that the ATRR is to be accounted for separately from the General Allowances for Possible Loan Losses, and shall not be included in the banking institution's capital or surplus. The rules also provide that no ATRR provisions are required if the banking institution writes down the assets in the requisite amount.

Question: How should the ATRR be reported in filings under the Federal Securities Laws?

Interpretive Response: It is the staff's understanding that the three banking agencies believe that those bank holding companies that have not written down the designated assets by the requisite amount and, therefore, are required to establish an ATRR should disclose the amount of the ATRR. The staff believes that such disclosure should be part of the discussion of Loan Loss Experience, Item IV of Guide 3. Part A under Item

IV calls for an analysis of loss experience in the form of a reconciliation of the allowance for loan losses, and the staff believes that it would be appropriate to show and discuss separately the ATRR in the context of that reconciliation.

Registrants should recognize that the amount provided as an ATRR, or the write off of the requisite amount, represents the identification of an amount which those regulatory agencies have determined should not be included as a part of the institution's capital or surplus for purposes of administration of the regulatory and supervisory functions of those agencies. In this context, the staff believes that disclosure of the ATRR, as part of the footnote required to be presented in a registrant's financial statements by Item 7(d) of Rule 9-03 of Regulation S-X, may provide a more complete explanation of charge offs and provisions for loan losses. It should be noted, however, that the ATRR amount to be excluded from the institution's capital and surplus does not address the more general issue of the adequacy of allowances for any particular bank holding company's loans. It is still the responsibility of each registrant to determine whether GAAP require an additional provision for losses in excess of the amount required to be included in an ATRR (or the requisite amount written off).

J. Deleted by SAB 103

K. Application of Article 9 and Guide 3

Facts: Article 9 of Regulation S-X specifies the form and content of and requirements for financial statements for bank holding companies filing with the Commission. Similarly, bank holding companies disclose supplemental statistical disclosures in filings, pursuant to Industry Guide 3. No specific guidance as to the form and content of financial statements or supplemental disclosures has been promulgated for registrants which are not bank holding companies but which are engaged in similar lending and deposit activities.¹

Question: Should non-bank holding company registrants with material amounts of lending and deposit activities file financial statements and make disclosures called for by Article 9 of Regulation S-X and Industry Guide 3?

¹ The Commission staff has been considering the need for more specific guidance in the area but believes that the FASB project on financial instruments may make Commission action in this area unnecessary. In the interim, this bulletin provides the staff's views with respect to filings by similar entities such as saving and loan holding companies.

Interpretive Response: In the staff's view, Article 9 and Guide 3, while applying literally only to bank holding companies, provide useful guidance to certain other registrants, including savings and loan holding companies, on certain disclosures relevant to an understanding of the registrant's operations. Thus, to the extent particular guidance is relevant and material to the operations of an entity, the staff believes the specified information, or comparable data, should be provided.

For example, in accordance with Guide 3, bank holding companies disclose information about yields and costs of various assets and liabilities. Further, bank holding companies provide certain information about maturities and repricing characteristics of various assets and liabilities. Such companies also disclose risk elements, such as nonaccrual and past due items in the lending portfolio. The staff believes that this information and other relevant data would be material to a description of business of other registrants with material lending and deposit activities and accordingly, the specified information and/or comparable data (such as scheduled item disclosure for risk elements) should be provided.

In contrast, other requirements of Article 9 and Guide 3 may not be material or relevant to an understanding of the financial statements of some financial institutions. For example, bank holding companies present average balance sheet information, because period-end statements might not be representative of bank activity throughout the year. Some financial institutions other than bank holding companies may determine that average balance sheet disclosure does not provide significant additional information. Others may determine that assets and liabilities are subject to sufficient volatility that average balance information should be presented.

Pursuant to Article 9, the income statements of bank holding companies use a "net interest income" presentation. Similarly, bank holding companies present the aggregate market value, at the balance sheet date, of investment securities, on the face of the balance sheet. The staff believes that such disclosures and other relevant information should also be provided by other registrants with material lending and deposit activities.

L. Income Statement Presentation of Casino-Hotels

Facts: Registrants having casino-hotel operations present separately within the

income statement amounts of revenue attributable to casino, hotel and restaurant operations, respectively.

Question: What is the appropriate income statement presentation of expenses attributable to casino-hotel activities?

Interpretive Response: The staff believes that the expenses attributable to each of the separate revenue producing activities of casino, hotel and restaurant operations should be separately presented on the face of the income statement. Such a presentation is consistent with the general reporting format for income statement presentation under Regulation S-X (Rules 5-03.1 and 5-03.2) which requires presentation of amounts of revenues and related costs and expenses applicable to major revenue providing activities. This detailed presentation affords an analysis of the relative contribution to operating profits of each of the revenue producing activities of a typical casino-hotel operation.

M. Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period

Facts: An accounting standard has been issued¹ that does not require adoption until some future date. A registrant is required to include financial statements in filings with the Commission after the issuance of the standard but before it is adopted by the registrant.

Question 1: Does the staff believe that these filings should include disclosure of the impact that the recently issued accounting standard will have on the financial position and results of operations of the registrant when such standard is adopted in a future period?

Interpretive Response: Yes. The Commission addressed a similar issue with respect to Statement 52 and concluded that "The Commission also believes that registrants that have not yet adopted Statement 52 should discuss the potential effects of adoption in registration statements and reports filed with the Commission."² The staff believes that this disclosure guidance applies to all accounting standards which have been issued but not yet adopted by the registrant unless the impact on its financial position and

results of operations is not expected to be material.³ MD&A⁴ requires registrants to provide information with respect to liquidity, capital resources and results of operations and such other information that the registrant believes to be necessary to understand its financial condition and results of operations. In addition, MD&A requires disclosure of presently known material changes, trends and uncertainties that have had or that the registrant reasonably expects will have a material impact on future sales, revenues or income from continuing operations. The staff believes that disclosure of impending accounting changes is necessary to inform the reader about expected impacts on financial information to be reported in the future and, therefore, should be disclosed in accordance with the existing MD&A requirements. With respect to financial statement disclosure, GAAS⁵ specifically address the need for the auditor to consider the adequacy of the disclosure of impending changes in accounting principles if (a) the financial statements have been prepared on the basis of accounting principles that were acceptable at the financial statement date but that will not be acceptable in the future and (b) the financial statements will be restated in the future as a result of the change. The staff believes that recently issued accounting standards may constitute material matters and, therefore, disclosure in the financial statements should also be considered in situations where the change to the new accounting standard will be accounted for in financial statements of future periods, prospectively or with a cumulative catch-up adjustment.

Question 2: Does the staff have a view on the types of disclosure that would be meaningful and appropriate when a new accounting standard has been issued but not yet adopted by the registrant?

Interpretive Response: The staff believes that the registrant should evaluate each new accounting standard to determine the appropriate disclosure and recognizes that the level of information available to the registrant will differ with respect to various standards and from one registrant to another. The objectives of the disclosure should be to (1) notify the reader of the

disclosure documents that a standard has been issued which the registrant will be required to adopt in the future and (2) assist the reader in assessing the significance of the impact that the standard will have on the financial statements of the registrant when adopted. The staff understands that the registrant will only be able to disclose information that is known.

The following disclosures should generally be considered by the registrant:

- A brief description of the new standard, the date that adoption is required and the date that the registrant plans to adopt, if earlier.
- A discussion of the methods of adoption allowed by the standard and the method expected to be utilized by the registrant, if determined.
- A discussion of the impact that adoption of the standard is expected to have on the financial statements of the registrant, unless not known or reasonably estimable. In that case, a statement to that effect may be made.
- Disclosure of the potential impact of other significant matters that the registrant believes might result from the adoption of the standard (such as technical violations of debt covenant agreements, planned or intended changes in business practices, etc.) is encouraged.

N. Disclosures of the Impact of Assistance From Federal Financial Institution Regulatory Agencies

Facts: An entity receives financial assistance from a federal regulatory agency in conjunction with either an acquisition of a troubled financial institution, transfer of nonperforming assets to a newly-formed entity, or other reorganization.

Question: What are the disclosure implications of the existence of regulatory assistance?

Interpretive Response: The staff believes that users of financial statements must be able to assess the impact of credit and other risks on a company following a regulatory assisted acquisition, transfer or other reorganization on a basis comparable to that disclosed by other institutions, *i.e.*, as if the assistance did not exist. In this regard, the staff believes that the amount of regulatory assistance should be disclosed separately and should be separately identified in the statistical information furnished pursuant to Industry Guide 3, to the extent it impacts such information.^{1,2} Further,

¹ Some registrants may want to disclose the potential effects of proposed accounting standards not yet issued, (*e.g.*, exposure drafts). Such disclosures, which generally are not required because the final standard may differ from the exposure draft, are not addressed by this SAB. See also FRR 26.

² FRR 6, Section 2.

³ In those instances where a recently issued standard will impact the preparation of, but not materially affect, the financial statements, the registrant is encouraged to disclose that a standard has been issued and that its adoption will not have a material effect on its financial position or results of operations.

⁴ Item 303 of Regulation S-K.

⁵ See AU 9410.13-18.

¹ The staff has previously expressed its views regarding acceptable methods of compliance with

the nature, extent and impact of such assistance needs to be fully discussed in Management's Discussion and Analysis.³

Topic 12: Oil and Gas Producing Activities

A. Accounting Series Release 257—Requirements for Financial Accounting and Reporting Practices for Oil and Gas Producing Activities

1. Estimates of Quantities of Proved Reserves

Facts: Rule 4–10 contains definitions of proved reserves, proved developed reserves, and proved undeveloped reserves to be used in determining quantities of oil and gas reserves to be reported in filings with the Commission.

Question 1: The definition of proved reserves states that reservoirs are considered proved if “economic producibility is supported by either actual production or conclusive formation test.” May oil and gas reserves be considered proved if economic producibility is supported only by core analyses and/or electric or other log interpretations?

Interpretive Response: Economic producibility of estimated proved reserves can be supported to the satisfaction of the Office of Engineering if geological and engineering data demonstrate with reasonable certainty that those reserves can be recovered in future years under existing economic and operating conditions. The relative importance of the many pieces of geological and engineering data which should be evaluated when classifying reserves cannot be identified in advance. In certain instances, proved reserves may be assigned to reservoirs on the basis of a combination of electrical and other type logs and core analyses which indicate the reservoirs are analogous to similar reservoirs in the same field which are producing or have demonstrated the ability to produce on a formation test.

Question 2: In determining whether “proved undeveloped reserves” encompass acreage on which fluid injection (or other improved recovery technique) is contemplated, is it appropriate to distinguish between (i) fluid injection used for pressure maintenance during the early life of a

field and (ii) fluid injection used to effect secondary recovery when a field is in the late stages of depletion? The definition in Rule 4–10(a)(4) does not make this distinction between pressure maintenance activity and fluid injection undertaken for purposes of secondary recovery.

Interpretive Response: The Office of Engineering believes that the distinction identified in the above question may be appropriate in a few limited circumstances, such as in the case of certain fields in the North Sea. The staff will review estimates of proved reserves attributable to fluid injection in the light of the strength of the evidence presented by the registrant in support of a contention that enhanced recovery will be achieved.

Question 3: What volumes of natural gas liquids should be reported as net reserves, that portion recovered in a gas processing plant and allocated to the leasehold interest or the total recovered by a plant from net interest gas?

Interpretive Response: Companies should report reserves of natural gas liquids which are net to their leasehold interests, *i.e.*, that portion recovered in a processing plant and allocated to the leasehold interest. It may be appropriate in the case of natural gas liquids not clearly attributable to leasehold interests ownership to follow instructions to Item 3 of Securities Act Industry Guide 2 and report such reserves separately and describe the nature of the ownership.

Question 4: What pressure base should be used for reporting gas and production, 14.73 psia or the pressure base specified by the state?

Interpretive Response: The reporting instructions to the Department of Energy's Form EIA–28 specify that natural gas reserves are to be reported at 14.73 psia and 60 degrees F. There is no pressure base specified in Regulation S–X or S–K. At the present time the staff will not object to natural gas reserves and production data calculated at other pressure bases, if such other pressure bases are identified in the filing.

2. Estimates of Future Net Revenues

Facts: Paragraphs 30–34 of Statement 69 require the disclosure of the standardized measure of discounted future net cash flows from production of proved oil and gas reserves, computed by applying year-end prices of oil and gas (with consideration of price changes only to the extent provided by contractual arrangements) to estimated future production as of the latest balance sheet date, less estimated future expenditures (based on current costs) of developing and producing the proved

reserves, and assuming continuation of existing economic conditions.

Question 1: For purposes of determining reserves and estimated future net revenues, what price should be used for gas which will be produced after an existing contract expires or after the redetermination date in a contract?

Interpretive Response: The price to be used for gas which will be produced after a contract expires or has a redetermination is the current market price at the end of the fiscal year for that category of gas. This price may be increased thereafter only for additional fixed and determinable escalations, as appropriate, for that category of gas. A fixed and determinable escalation is one which is specified in amount and is not based on future events such as rates of inflation.

Question 2: What price should be applied to gas which at the end of a fiscal year is not yet subject to a gas sales contract?

Interpretive Response: The price to be used is the current market price for similarly situated gas at the end of the fiscal year provided the company can reasonably expect to sell the gas at the prevailing market price.

Question 3: To what extent should price increases announced by OPEC or by certain government agencies not yet effective at the date of the reserve report be considered in determining current prices?

Interpretive Response: Current prices should not reflect price increases announced but not yet effective at the date of the reserve valuation, *i.e.*, the end of the fiscal year.

3. Disclosure of Reserve Information

a. Deleted by SAB 103

b. Unproved properties

Facts: Disclosures of reserve information are based on estimated quantities of proved reserves of oil and gas. Regulation S–K prohibits disclosure of estimated quantities of probable or possible reserves of oil and gas and any estimated value thereof in any document publicly filed with the Commission.

Question: What types of disclosures will be permitted by registrants who wish to indicate that some of their properties have value other than that attributable to proved reserves?

Interpretive Response: The Office of Engineering has, for the past several years, suggested to registrants the following form of disclosure for undeveloped lease acreage:

In addition to proved reserves, the estimated (or appraised) value of leases or parts of leases to which proved reserves cannot be attributable is \$xxx.

this principle in the minutes of EITF Issue 88–19, and an announcement by the SEC Observer to the EITF at the February 23, 1989 meeting.

² See EITF Issue 88–19 for guidance on the appropriate period in which to record certain types of regulatory assistance.

³ See Section 501.06.c. of the Financial Reporting Codification for further discussion of the MD&A disclosures of the effects of regulatory assistance.

The registrant should describe the basis on which the estimate was made. For example, such estimated values are often based on the market demand for leasehold acreage which, in turn, is based on a number of qualitative factors such as proximity to production. If the disclosed amount is based on an appraisal, the person making the appraisal should be named.

c. Limited partnership 10-K reports

Facts: Securities Act Industry Guide 2 contains an exemption from the requirements of the Guide to disclose certain information relating to oil and gas operations for "limited partnerships or joint ventures that conduct, operate, manage, or report upon oil and gas drilling income programs which acquire properties either for drilling and production, or for production of oil, gas, or geothermal steam." Regulation S-X does not contain a similar exemption from the supplemental disclosure requirements of Statement 69.

Limited partnership agreements often contain buy-out provisions under which the general partner agrees to purchase limited partnership interests that are offered for sale, based upon a specified valuation formula. Because of these arrangements, the requirements for disclosure of reserve value information may be of little significance to the limited partners.

Question: Must the financial statements of limited partnerships included in reports on Form 10-K contain the disclosures of estimated future net revenues, present values and changes therein, and supplemental summary of oil and gas activities specified by paragraphs 24-34 of Statement 69?

Interpretive Response: The staff will not take exception to the omission of these disclosures in a limited partnership Form 10-K if reserve value information is available to the limited partners pursuant to the partnership agreement (even though the valuations may be computed differently and may be as of a date other than year end). However, the staff will require all of the information specified by these paragraphs of Statement 69 for partnerships which are the subject of a merger or exchange offer under which various limited partnerships are to be combined into a single entity.

d. Limited partnership registration statements

Facts: The staff requires that a registration statement relating to an offering of limited partnership interests include the most recent year-end balance sheet of the general partner. This is considered necessary for

purposes of assessing the financial responsibility of the general partner.

Question: What disclosures of oil and gas reserve information must accompany the balance sheet of the general partner?

Interpretive Response: Disclosures should include oil and gas reserve information that pertains to the balance sheet, *i.e.*, the estimated year-end quantities of proved oil and gas reserves and the estimated future net revenues and present values thereof specified by paragraphs 10-17 and 30-34, respectively, of Statement 69.

e. Rate regulated companies

Question: If a company has cost-of-service oil and gas producing properties, how should they be treated in the supplemental disclosures of reserve quantities and related future net revenues provided pursuant to paragraphs 30-34 of Statement 69?

Interpretive Response: Rule 4-10 provides that registrants may give effect to differences arising from the ratemaking process for cost-of-service oil and gas properties. Accordingly, in these circumstances, the staff believes that the company's supplemental reserve quantity disclosures should indicate separately the quantities associated with properties subject to cost-of-service ratemaking, and that it is appropriate to exclude those quantities from the future net revenue disclosures. The company should also disclose the nature and impact of its cost-of-service ratemaking, including the unamortized cost included in the balance sheet.

4. Deleted by SAB 103

B. Deleted by SAB 103

C. Methods of Accounting by Oil and Gas Producers

1. First-Time Registrants

Facts: In ASR 300, the Commission announced that it would allow registrants to change methods of accounting for oil and gas producing activities so long as such changes were in accordance with GAAP. Accordingly, the Commission stated that changes from the full cost method to the successful efforts method would not require a preferability letter because of the position expressed in Statement 25 that successful efforts is considered preferable by the FASB for accounting changes. Changes to full cost, however, would require justification by the company making the change and filing of a preferability letter from the company's independent accountants.

Question: How does this policy apply to a nonpublic company which changes its accounting method in connection

with a forthcoming public offering or initial registration under either the 1933 Act or 1934 Act?

Interpretive Response: The Commission's policy that first time registrants may change their previous accounting methods without filing a preferability letter is applicable. Therefore, such a company may change to the full cost method without filing a preferability letter.

2. Consistent Use of Accounting Methods Within a Consolidated Entity

Facts: Rule 4-10(c) of Regulation S-X states that "a reporting entity that follows the full cost method shall apply that method to all of its operations and to the operations of its subsidiaries."

Question 1: If a parent company uses the successful efforts method of accounting for oil and gas producing activities, may a subsidiary of the parent use the full cost method?

Interpretive Response: No. The use of different methods of accounting in the consolidated financial statements by a parent company and its subsidiary would be inconsistent with the full cost requirement that a parent and its subsidiaries all use the same method of accounting.

The staff's general policy is that an enterprise should account for all its like operations in the same manner. However, Rule 4-10 of Regulation S-X provides that oil and gas companies with cost-of-service oil and gas properties may give effect to any differences resulting from the ratemaking process, including regulatory requirements that a certain accounting method be used for the cost-of-service properties.

Question 2: Must the method of accounting (full cost or successful efforts) followed by a registrant for its oil and gas producing activities also be followed by any fifty percent or less owned companies in which the registrant carries its investment on the equity method (equity investees)?

Interpretive Response: No. Conformity of accounting methods between a registrant and its equity investees, although desirable, may not be practicable and thus is not required. However, if a registrant proportionately consolidates its equity investees, it will be necessary to present them all on the same basis of accounting.

D. Application of Full Cost Method of Accounting

1. Treatment of Income Tax Effects in the Computation of the Limitation on Capitalized Costs

Facts: Item (D) of Rule 4-10(c)(4)(i) of Regulation S-X states that the income

tax effects related to the properties involved should be deducted in computing the full cost ceiling.

Question 1: What specific types of income tax effects should be considered in computing the income tax effects to be deducted from estimated future net revenues?

Interpretive Response: The rule refers to income tax effects generally. Thus, the computation should take into account (i) the tax basis of oil and gas properties, (ii) net operating loss carryforwards, (iii) foreign tax credit carryforwards, (iv) investment tax credits, (v) minimum taxes on tax

preference items, and (vi) the impact of statutory (percentage) depletion.

It may often be difficult to allocate net operating loss carryforwards (NOLs) between oil and gas assets and other assets. However, to the extent that the NOLs are clearly attributable to oil and gas operations and are expected to be realized within the carryforward period, they should be added to tax basis.

Similarly, to the extent that investment tax credit (ITC) carryforwards and foreign tax credit carryforwards are attributable to oil and gas operations and are expected to be realized within the carryforward period,

they should be considered as a deduction from the tax effect otherwise computed. Consideration of NOLs and ITC or foreign tax credit carryforwards should not, of course, reduce the total tax effect below zero.

Question 2: How should the tax effect be computed considering the various factors discussed above?

Interpretive Response: Theoretically, taxable income and tax could be determined on a year-by-year basis and the present value of the related tax computed. However, the "shortcut" method illustrated below is also acceptable.

Assumptions:

Capitalized Costs of Oil and Gas Assets			\$500,000
Accumulated DD&A			(100,000)
Book basis of oil and gas assets			400,000
Related deferred income taxes			35,000
Net book basis to be recovered			\$365,000
NOL carryforward*			\$ 20,000
Foreign tax credit carryforward*			\$ 1,000
ITC—Carryforward*	\$2,000		
Present value of ITC relating to future development costs	1,500		\$ 3,500
Estimated preference (minimum) tax on percentage depletion in excess of cost depletion			\$ 500
Tax basis of oil and gas assets			\$270,000
Present value of statutory depletion attributable to future deductions			\$ 10,000
Statutory tax rate (percent)			46%
Present value of future net revenues from proved oil and gas reserves			\$272,000
Cost of properties not being amortized			\$ 55,000
Lower of cost or estimated fair value of unproved properties included in costs being amortized			\$ 49,000
CALCULATION			
Present value of future net revenue			\$272,000
Cost of properties not being amortized			55,000
Lower of cost or estimated fair value of unproved properties included in costs being amortized			49,000
Tax Effects:			
Total of above items			\$376,000
Less: Tax basis of properties	(270,000)		
Statutory depletion	(10,000)		
NOL carryforward	(20,000)	(300,000)	
Future taxable income		76,000	
Tax rate (percent)		× 46%	
Tax payable at statutory rate		(34,960)	
ITC		3,500	
Foreign tax credit carryforward		1,000	
Estimated preference tax		(500)	
Total tax effects			(30,960)
Cost Center Ceiling			\$345,040
Less: Net book basis			365,000
REQUIRED WRITE-OFF, net of tax**			(\$ 19,960)

* All carryforward amounts in this example represent amounts which are available for tax purposes and which related to oil and gas operations.
 ** For accounting purposes, the gross write-off should be recorded to adjust both the oil and gas properties account and the related deferred income taxes.

2. Exclusion of Costs From Amortization

Facts: Rule 4–10(c)(3)(ii) indicates that the costs of acquiring and evaluating unproved properties may be excluded from capitalized costs to be

amortized if the costs are unusually significant in relation to aggregate costs to be amortized. Costs of major development projects may also be incurred prior to ascertaining the

quantities of proved reserves attributable to such properties.

Question: At what point should amortization of previously excluded costs commence when proved reserves

have been established or when those reserves become marketable? For instance, a determination of proved reserves may be made before completion of an extraction plant necessary to process sour crude or a pipeline necessary to market the reserves. May the costs continue to be excluded from amortization until the plant or pipeline is in service?

Interpretive Response: No. The proved reserves and the costs allocable to such reserves should be transferred into the amortization base on an ongoing (well-by-well or property-by-property) basis as the project is evaluated and proved reserves are established. Once the determination of proved reserves has

been made, there is no justification for continued exclusion from the full cost pool, regardless of whether other factors prevent immediate marketing. Moreover, at the same time that the costs are transferred into the amortization base, it is also necessary in accordance with Interpretation 33 and Statement 34 to terminate capitalization of interest on such properties.

In this regard, registrants are reminded of their responsibilities not to delay recognizing reserves as proved once they have met the engineering standards.

3. Full Cost Ceiling Limitation

a. Exemptions for purchased properties

Facts: During 20x1, a registrant purchases proved oil and gas reserves in place ("the purchased reserves") in an arm's length transaction for the sum of \$9.8 million. Primarily because the registrant expects oil and gas prices to escalate, it paid \$1.2 million more for the purchased reserves than the "Present Value of Estimated Future Net Revenues" computed as defined in Rule 4-10(c)(4)(i)(A) of Regulation S-X. An analysis of the registrant's full cost center in which the purchased reserves are located at December 31, 20x1 is as follows:

[Amounts in 1,000]

	Total	Purchased reserves	Other proved properties	Unproved properties
Present value of estimated future net revenues	\$14,100	8,600	5,500	
Cost, net of amortization	\$16,300	9,800	5,500	1,000
Related deferred taxes	\$2,300		2,000	300
Income tax effects related to properties	\$2,500		2,500	
		Including purchased reserves	Excluding purchased reserves	
Comparison of capitalized costs with limitation on capitalized costs at December 31, 20x1.				
Capitalized costs, net of amortization		\$16,300	\$6,500	
Related deferred taxes		(2,300)	(2,300)	
Net book cost		14,000	4,200	
Present value of estimated future net revenues		14,100	5,500	
Lower of cost or market of unproved properties		1,000	1,000	
Income tax effects related to properties		(2,500)	(2,500)	
Limitation on capitalized costs		12,600	4,000	
Excess of capitalized costs over limitation on Capitalized costs, net of tax ...		\$1,400	\$200	

*For accounting purposes, the gross write-off should be recorded to adjust both the oil and gas properties account and the related deferred income taxes

Question: Is it necessary for the registrant to write down the carrying value of its full cost center at December 31, 20x1 by \$1,400,000?

Interpretive Response: Although the net carrying value of the full cost center exceeds the cost center's limitation on capitalized costs, the text of ASR 258 provides that a registrant may request an exemption from the rule if as a result of a major purchase of proved properties, a write down would be required even though the registrant believes the fair value of the properties in a cost center clearly exceeds the unamortized costs.

Therefore, to the extent that the excess carrying value relates to the purchased reserves, the registrant may seek a temporary waiver of the full-cost ceiling limitation from the staff of the Commission. Registrants requesting a waiver should be prepared to demonstrate that the additional value exists beyond reasonable doubt.

To the extent that the excess costs relate to properties other than the purchased reserves, however, a write-off should be recorded in the current period. In order to determine the portion of the total excess carrying value

which is attributable to properties other than the purchased reserves, it is necessary to perform the ceiling computation on a "with and without" basis as shown in the example above. Thus in this case, the registrant must record a write-down of \$200,000 applicable to other reserves. An additional \$1,200,000 write-down would be necessary unless a waiver were obtained.

b. Use of cash flow hedges in the computation of the limitation on capitalized costs

Facts: Rule 4-10(c)(4) of Regulation S-X provides, in pertinent part, that

capitalized costs, net of accumulated depreciation and amortization, and deferred income taxes, should not exceed an amount equal to the sum of [components that include] the present value of estimated future net revenues computed by applying current prices of oil and gas reserves (with consideration of price changes only to the extent provided by contractual arrangements) to estimated future production of proved oil and gas reserves as of the date of the latest balance sheet presented.

As of the reported balance sheet date, capitalized costs of an oil and gas producing company exceed the full cost limitation calculated under the above described rule based on current spot market prices for oil and natural gas. However, prior to the balance sheet date, the company enters into certain hedging arrangements for a portion of its future natural gas and oil production, thereby enabling the company to receive future cash flows that are higher than the estimated future cash flows indicated by use of the spot market price as of the reported balance sheet date. These arrangements qualify as cash flow hedges under the provisions of Statement 133 as amended and interpreted, and are documented, designated, and accounted for as such under the criteria of that standard.

Question: Under these circumstances, must the company use the higher prices to be received after taking into account the hedging arrangements ("hedge-adjusted prices") in calculating the current price of the quantities of its future production of oil and gas reserves covered by the hedges as of the reported balance sheet date?

Interpretive Response: Yes. Derivative contracts that qualify as hedging instruments in a cash flow hedge and are accounted for as such pursuant to Statement 133 represent the type of contractual arrangements for which consideration of price changes should be given under the existing rule. While the SEC staff has objected to previous proposals to consider various hedging techniques as being equivalent to the contractual arrangements permitted under the existing rules, the staff's objection was based on concerns that the lack of clear, consistent guidance in the accounting literature would lead to inconsistent application in practice. For example, prior to the adoption of Statement 133, hedging activities related to foreign exchange rates were addressed in Statement 52. The use of futures contracts as hedging arrangements was previously addressed in Statement 80. The guidance provided in these Statements differed from

Statement 133 in the criteria used to qualify for hedge accounting. However, the staff believes that Statement 133 and related guidance (including a more systematic approach to documentation) provides sufficient guidance so that comparable financial reporting in comparable factual circumstances should result.

This interpretive response reflects the SEC staff's view that, assuming compliance with the prerequisite accounting requirements, hedge-adjusted prices represent the best measure of estimated cash flows from future production of the affected oil and gas reserves to use in calculating the ceiling limitation. Nonetheless, the staff expects that oil and gas producing companies subject to the full cost rules will clearly indicate the effects of using cash flow hedges in calculating ceiling limitations within their financial statement footnotes. The staff further expects that disclosures will indicate the portion of future oil and gas production being hedged. The dollar amount that would have been charged to income had the effects of the cash flow hedges not been considered in calculating the ceiling limitation also should be disclosed.

The use of hedge-adjusted prices should be consistently applied in all reporting periods, including periods in which the hedge-adjusted price is less than the current spot market price. Oil and gas producers whose computation of the ceiling limitation includes hedge-adjusted prices because of the use of cash flow hedges also should consider the disclosure requirements under the SOP 94-6. Paragraph 14 of SOP 94-6 calls for disclosure when it is at least reasonably possible that the effects of cash flow hedges on capitalized costs on the reported balance sheet date will change in the near term due to one or more confirming events, such as potential future changes in commodity prices.

In addition, the use of cash flow hedges in calculating the ceiling limitation may represent a type of critical accounting policy that oil and gas producers should consider disclosing consistent with the cautionary advice provided in FR 60. Through this release, the Commission has encouraged companies to include, within their MD&A disclosures, full explanations, in plain English, of the judgments and uncertainties affecting the application of critical accounting policies, and the likelihood that materially different amounts would be reported under different conditions or using different assumptions.

The staff's guidance on this issue would apply to calculations of ceiling limitations both in interim and annual periods.

c. Effect of subsequent events on the computation of the limitation on capitalized costs

Facts: Rule 4-10(c)(4)(ii) of Regulation S-X provides that an excess of unamortized capitalized costs within a cost center over the related cost ceiling shall be charged to expense in the period the excess occurs.

Question: Assume that at the date of company's fiscal year-end, its capitalized costs of oil and gas producing properties exceed the limitation prescribed by Rule 4-10(c)(4) of Regulation S-X. Thus, a write down is indicated. Subsequent to year-end but before the date of the auditors' report on the company's financial statements, assume that one of two events occurs: (1) additional reserves are proved up on properties owned at year-end, or (2) price increases become known which were not fixed and determinable at year-end. The present value of future net revenues from the additional reserves or from the increased prices is sufficiently large that if the full cost ceiling limitation were recomputed giving effect to those factors as of year-end, the ceiling would more than cover the costs. It is necessary to record a write down?

Interpretive Response: No. In these cases, the proving up of additional reserves on properties owned at year-end or the increase in prices indicates that the capitalized costs were not in fact impaired at year-end. However, for purposes of the revised computation of the "ceiling," the net book costs capitalized as of year-end should be increased by the amount of any additional costs incurred subsequent to year-end to prove the additional reserves or by any related costs previously excluded from amortization.

While the fact pattern described herein relates to annual periods, the guidance on the effects of subsequent events applies equally to interim period calculations of the ceiling limitation. However, the staff cautions registrants that the process of considering subsequent price changes in the determination of whether a ceiling write-down is called for should be similar to the consideration given to other subsequent events under the auditing literature. The staff expects that the date selected for the ceiling recomputation will be consistent from period to period, and bear a logical relationship to the filing date of the affected financial statements. For example, it would seem logical that an oil and gas producing company would

consistently make whatever recalculations are necessary at the date the auditors are completing their interim reviews.

The registrant's financial statements should disclose that capitalized costs exceeded the limitation thereon at year-end and should explain why the excess was not charged against earnings. In addition, the registrant's supplemental disclosures of estimated proved reserve quantities and related future net revenues and costs should not give effect to the reserves proved up or the cost incurred after year-end or to the price increases occurring after year-end. However, such quantities and amounts may be disclosed separately, with appropriate explanations.

Registrants should be aware that oil and gas reserves related to properties acquired after year-end would not justify avoiding a write-off indicated as of year-end. Similarly, the effects of cash flow hedging arrangements entered into after year-end cannot be factored into the calculation of the ceiling limitation at year-end. Such acquisitions and financial arrangements do not confirm situations existing at year-end.

E. Financial Statements of Royalty Trusts

Facts: Several oil and gas exploration and production companies have created "royalty trusts." Typically, the creating company conveys a net profits interest in certain of its oil and gas properties to the newly created trust and then distributes units in the trust to its shareholders. The trust is a passive entity which is prohibited from entering into or engaging in any business or commercial activity of any kind and from acquiring any oil and gas lease, royalty or other mineral interest. The function of the trust is to serve as an agent to distribute the income from the net profits interest. The amount to be periodically distributed to the unitholders is defined in the trust agreement and is typically determined based on the cash received from the net profits interest less expenses of the trustee. Royalty trusts have typically reported their earnings on the basis of cash distributions to unitholders. The net profits interest paid to the trust for any month is based on production from a preceding month; therefore, the method of accounting followed by the trust for the net profits interest income is different from the creating company's method of accounting for the related revenue.

Question: Will the staff accept a statement of distributable income which reflects the amounts to be distributed for the period in question under the terms

of the trust agreement in lieu of a statement of income prepared under GAAP?

Interpretive Response: Yes. Although financial statements filed with the Commission are normally required to be prepared in accordance with GAAP, the Commission's rules provide that other presentations may be acceptable in unusual situations. Since the operations of a royalty trust are limited to the distribution of income from the net profits interests contributed to it, the staff believes that the item of primary importance to the reader of the financial statements of the royalty trust is the amount of the cash distributions to the unitholders for the period reported. Should there be any change in the nature of the trust's operations due to revisions in the tax laws or other factors, the staff's interpretation would be reexamined.

A note to the financial statements should disclose the method used in determining distributable income and should also describe how distributable income as reported differs from income determined on the basis of GAAP.

F. Gross Revenue Method of Amortizing Capitalized Costs

Facts: Rule 4-10(c)(3)(iii) of Regulation S-X states in part:

Amortization shall be computed on the basis of physical units, with oil and gas converted to a common unit of measure on the basis of their approximate relative energy content, unless economic circumstances (related to the effects of regulated prices) indicate that use of units of revenue is a more appropriate basis of computing amortization. In the latter case, amortization shall be computed on the basis of current gross revenues (excluding royalty payments and net profits disbursements) from production in relation to future gross revenues based on current prices (including consideration of changes in existing prices provided only by contractual arrangements), from estimated production of proved oil and gas reserves.

Question: May entities using the full cost method of accounting for oil and gas producing activities compute amortization based on the gross revenue method described in the above rule when substantial production is not subject to pricing regulation?

Interpretive Response: Yes. Under the existing rules for cost amortization adopted in ASR 258, the use of the gross revenue method of amortization was permitted in those circumstances where, because of the effect of existing pricing regulations, the use of the units of production method would result in an amortization provision that would be inconsistent with the current prices being received. While the effect of regulation on gas prices has lessened,

factors other than price regulation (such as changes in typical contract lengths and methods of marketing natural gas) have caused oil and gas prices to be disproportionate to their relative energy content. The staff therefore believes that it may be more appropriate for registrants to compute amortization based on the gross revenue method whenever oil and gas sales prices are disproportionate to their relative energy content to the extent that the use of the units of production method would result in an improper matching of the costs of oil and gas production against the related revenue received. The method should be consistently applied and appropriately disclosed within the financial statements.

G. Inclusion of Methane Gas in Proved Reserves

Facts: Because of a concern over worldwide oil and gas supplies, Congress, in 1980, provided for tax incentives (credits) for the production of oil and gas from other than conventional sources. As a consequence, significant amounts of gas are now recovered from seams of coal beds. This gas is referred to as coalbed methane. It is produced using conventional drilling methods, but for various reasons, it may be more costly to produce than oil and gas recovered from customary sources and some reserves may not be economical without the tax credits.

Rule 4-10(a)(1)(i)(A) of Regulation S-X indicates that oil and gas producing activities include the search for crude oil, including condensate and natural gas liquids, or natural gas in their natural states and original locations. Rule 4-10(a)(2)(iii)(D) of Regulation S-X states that estimates of proved reserves do not include (among other things) natural gas that can be recovered from coal.¹ In addition, the definition of proved oil and gas reserves includes a provision that the quantities of natural gas be recovered from existing reservoirs. Under these definitions, "coalbed methane" gas has generally not been included in the disclosures in Commission filings required by Statement 69. Further, coalbed methane has generally not been counted in proved oil and gas reserves for purposes of the full cost ceiling test in Rule 4-10(c)(4) since that test is based on the same definition of proved oil and gas reserves.

Question: Is it appropriate to consider coalbed methane gas within the definition of proved reserves for purposes of the disclosures relating to

¹ Similar language appears in Statements 19 and 25.

oil and gas producing activities and the full cost ceiling test?

Interpretive Response: Yes. The prohibition against the inclusion of gas derived from coal was meant to apply to the recovery of hydrocarbons from the processing of coal. The extraction of methane gas from coalbed seams using conventional methods was not contemplated at the time Rule 4–10(a) was developed. The staff believes that, since coalbed methane gas can be recovered from coal in its natural state and original location, it should be included in proved reserves, provided that it complies in all other respects with the definition of proved oil and gas reserves as specified in Rule 4–10(a)(2) including the requirement that methane production be economical at current prices, costs (net of the tax credit) and existing operating conditions.² Methane gas from coalbeds (like any other hydrocarbon obtained from conventional reservoirs) that cannot be produced at a profit under current economic and operating conditions, or for which there is no market or any existing method of delivery to the market, cannot be included in the category of proved reserves.

In instances where methane gas is deemed to be economically producible only as a consequence of existing Federal tax incentives, the staff believes that additional disclosure should be provided as to the specific quantities and values of reported proved reserves that are dependent on existing U.S. tax policy together with any other information necessary to inform readers of the risks attendant with any future change to existing Federal tax policy.

Topic 13: Revenue Recognition

A. Selected Revenue Recognition Issues

1. Revenue Recognition—General

The accounting literature on revenue recognition includes both broad conceptual discussions as well as certain industry-specific guidance. Examples of existing literature on revenue recognition include Statements 13, 45, 48, 49, 50, 51, and 66; Opinion 10; ARBs 43 (Chapter 1a) and 45; SOPs 81–1 and 97–2; EITF Issues 88–18, 91–9, 95–1, and 95–4; and Concepts Statement 5.¹ If a transaction is within

the scope of specific authoritative literature that provides revenue recognition guidance, that literature should be applied. However, in the absence of authoritative literature addressing a specific arrangement or a specific industry, the staff will consider the existing authoritative accounting standards as well as the broad revenue recognition criteria specified in the FASB's conceptual framework that contain basic guidelines for revenue recognition.

Based on these guidelines, revenue should not be recognized until it is realized or realizable and earned.² Concepts Statement 5, paragraph 83(b) states that “an entity's revenue-earning activities involve delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations, and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues” [footnote reference omitted]. Paragraph 84(a) continues “the two conditions (being realized or realizable and being earned) are usually met by the time product or merchandise is delivered or services are rendered to customers, and revenues from manufacturing and selling activities and gains and losses from sales of other assets are commonly recognized at time of sale (usually meaning delivery)” [footnote reference omitted]. In addition, paragraph 84(d) states that “If services are rendered or rights to use assets extend continuously over time (for example, interest or rent), reliable measures based on contractual prices established in advance are commonly available, and revenues may be recognized as earned as time passes.”

The staff believes that revenue generally is realized or realizable and earned when all of the following criteria are met:

- Persuasive evidence of an arrangement exists,³

auditing procedures for revenue recognition and identifies indicators of improper revenue recognition.

² Concepts Statement 5, paragraphs 83–84; ARB 43, Chapter 1A, paragraph 1; Opinion 10, paragraph 12. The citations provided herein are not intended to present the complete population of citations where a particular criterion is relevant. Rather, the citations are intended to provide the reader with additional reference material.

³ Concepts Statement 3, Qualitative Characteristics of Accounting Information, paragraph 63 states “Representational faithfulness is correspondence or agreement between a measure or description and the phenomenon it purports to represent.” The staff believes that evidence of an exchange arrangement must exist to determine if the accounting treatment represents faithfully the transaction. See also SOP 97–2, paragraph 8. The

• Delivery has occurred or services have been rendered,⁴

- The seller's price to the buyer is fixed or determinable,⁵ and
- Collectibility is reasonably assured.⁶

2. Persuasive Evidence of an Arrangement

Question 1

Facts: Company A has product available to ship to customers prior to the end of its current fiscal quarter. Customer Beta places an order for the product, and Company A delivers the product prior to the end of its current fiscal quarter. Company A's normal and customary business practice for this class of customer is to enter into a written sales agreement that requires the signatures of the authorized representatives of the Company and its customer to be binding. Company A prepares a written sales agreement, and its authorized representative signs the agreement before the end of the quarter. However, Customer Beta does not sign the agreement because Customer Beta is awaiting the requisite approval by its legal department. Customer Beta's purchasing department has orally agreed to the sale and stated that it is highly likely that the contract will be approved the first week of Company A's next fiscal quarter.

Question: May Company A recognize the revenue in the current fiscal quarter for the sale of the product to Customer Beta when (1) the product is delivered by the end of its current fiscal quarter and (2) the final written sales agreement is executed by Customer Beta's authorized representative within a few

use of the term “arrangement” in this SAB is meant to identify the final understanding between the parties as to the specific nature and terms of the agreed-upon transaction.

⁴ Concepts Statement 5, paragraph 84(a), (b), and (d). Revenue should not be recognized until the seller has substantially accomplished what it must do pursuant to the terms of the arrangement, which usually occurs upon delivery or performance of the services.

⁵ Concepts Statement 5, paragraph 83(a); Statement 48, paragraph 6(a); SOP 97–2, paragraph 8. SOP 97–2 defines a “fixed fee” as a “fee required to be paid at a set amount that is not subject to refund or adjustment. A fixed fee includes amounts designated as minimum royalties.” Paragraphs 26–33 of SOP 97–2 discuss how to apply the fixed or determinable fee criterion in software transactions. The staff believes that the guidance in paragraphs 26 and 30–33 is appropriate for other sales transactions where authoritative guidance does not otherwise exist. The staff notes that paragraphs 27 through 29 specifically consider software transactions, however, the staff believes that guidance should be considered in other sales transactions in which the risk of technological obsolescence is high.

⁶ ARB 43, Chapter 1A, paragraph 1 and Opinion 10, paragraph 12. See also Concepts Statement 5, paragraph 84(g) and SOP 97–2, paragraph 8.

² Proved oil and gas reserves are the estimated quantities of crude oil, natural gas, and natural gas liquids which geological and engineering data demonstrate with reasonable certainty to be recoverable in future years from known reservoirs under existing economic and operating conditions. (Emphasis added.)

¹ In February 1999, the AICPA published a booklet entitled “Audit Issues in Revenue Recognition.” This booklet provides an overview of the current authoritative accounting literature and

days after the end of the current fiscal quarter?

Interpretive Response: No. Generally the staff believes that, in view of Company A's business practice of requiring a written sales agreement for this class of customer, persuasive evidence of an arrangement would require a final agreement that has been executed by the properly authorized personnel of the customer. In the staff's view, Customer Beta's execution of the sales agreement after the end of the quarter causes the transaction to be considered a transaction of the subsequent period.¹ Further, if an arrangement is subject to subsequent approval (e.g., by the management committee or board of directors) or execution of another agreement, revenue recognition would be inappropriate until that subsequent approval or agreement is complete.

Customary business practices and processes for documenting sales transactions vary among companies and industries. Business practices and processes may also vary within individual companies (e.g., based on the class of customer, nature of product or service, or other distinguishable factors). If a company does not have a standard or customary business practice of relying on written contracts to document a sales arrangement, it usually would be expected to have other forms of written or electronic evidence to document the transaction. For example, a company may not use written contracts but instead may rely on binding purchase orders from third parties or on-line authorizations that include the terms of the sale and that are binding on the customer. In that situation, that documentation could represent persuasive evidence of an arrangement.

The staff is aware that sometimes a customer and seller enter into "side" agreements to a master contract that effectively amend the master contract. Registrants should ensure that appropriate policies, procedures, and internal controls exist and are properly documented so as to provide reasonable assurances that sales transactions, including those affected by side agreements, are properly accounted for in accordance with GAAP and to ensure compliance with Section 13 of the Securities Exchange Act of 1934 (i.e., the Foreign Corrupt Practices Act). Side agreements could include cancellation, termination, or other provisions that affect revenue recognition. The existence of a subsequently executed side agreement may be an indicator that

the original agreement was not final and revenue recognition was not appropriate.

Question 2

Facts: Company Z enters into an arrangement with Customer A to deliver Company Z's products to Customer A on a consignment basis. Pursuant to the terms of the arrangement, Customer A is a consignee, and title to the products does not pass from Company Z to Customer A until Customer A consumes the products in its operations. Company Z delivers product to Customer A under the terms of their arrangement.

Question: May Company Z recognize revenue upon delivery of its product to Customer A?

Interpretive Response: No. Products delivered to a consignee pursuant to a consignment arrangement are not sales and do not qualify for revenue recognition until a sale occurs. The staff believes that revenue recognition is not appropriate because the seller retains the risks and rewards of ownership of the product and title usually does not pass to the consignee.

Other situations may exist where title to delivered products passes to a buyer, but the substance of the transaction is that of a consignment or a financing. Such arrangements require a careful analysis of the facts and circumstances of the transaction, as well as an understanding of the rights and obligations of the parties, and the seller's customary business practices in such arrangements. The staff believes that the presence of one or more of the following characteristics in a transaction precludes revenue recognition even if title to the product has passed to the buyer:

1. The buyer has the right to return the product and:

(a) The buyer does not pay the seller at the time of sale, and the buyer is not obligated to pay the seller at a specified date or dates.²

(b) the buyer does not pay the seller at the time of sale but rather is obligated to pay at a specified date or dates, and the buyer's obligation to pay is contractually or implicitly excused until the buyer resells the product or subsequently consumes or uses the product,³

(c) the buyer's obligation to the seller would be changed (e.g., the seller would

forgive the obligation or grant a refund) in the event of theft or physical destruction or damage of the product,⁴

(d) the buyer acquiring the product for resale does not have economic substance apart from that provided by the seller,⁵ or

(e) the seller has significant obligations for future performance to directly bring about resale of the product by the buyer.⁶

2. The seller is required to repurchase the product (or a substantially identical product or processed goods of which the product is a component) at specified prices that are not subject to change except for fluctuations due to finance and holding costs,⁷ and the amounts to be paid by the seller will be adjusted, as necessary, to cover substantially all fluctuations in costs incurred by the buyer in purchasing and holding the product (including interest).⁸ The staff believes that indicators of the latter condition include:

(a) The seller provides interest-free or significantly below market financing to the buyer beyond the seller's customary sales terms and until the products are resold,

(b) the seller pays interest costs on behalf of the buyer under a third-party financing arrangement, or

(c) the seller has a practice of refunding (or intends to refund) a portion of the original sales price representative of interest expense for the period from when the buyer paid the seller until the buyer resells the product.

3. The transaction possesses the characteristics set forth in EITF Issue 95-1 and does not qualify for sales-type lease accounting.

4. The product is delivered for demonstration purposes.⁹

This list is not meant to be a checklist of all characteristics of a consignment or a financing arrangement, and other characteristics may exist. Accordingly, the staff believes that judgment is necessary in assessing whether the substance of a transaction is a consignment, a financing, or other arrangement for which revenue recognition is not appropriate. If title to

⁴ Statement 48, paragraph 6(c).

⁵ Statement 48, paragraph 6(d).

⁶ Statement 48, paragraph 6(e).

⁷ Statement 49, paragraph 5(a). Paragraph 5(a) provides examples of circumstances that meet this requirement. As discussed further therein, this condition is present if (a) a resale price guarantee exists, (b) the seller has an option to purchase the product, the economic effect of which compels the seller to purchase the product, or (c) the buyer has an option whereby it can require the seller to purchase the product.

⁸ Statement 49, paragraph 5(b).

⁹ See SOP 97-2, paragraph 25.

¹ AU Section 560.05.

² Statement 48, paragraphs 6(b) and 22.

³ Statement 48, paragraphs 6(b) and 22. The arrangement may not specify that payment is contingent upon subsequent resale or consumption. However, if the seller has an established business practice permitting customers to defer payment beyond the specified due date(s) until the products are resold or consumed, then the staff believes that the seller's right to receive cash representing the sales price is contingent.

the goods has passed but the substance of the arrangement is not a sale, the consigned inventory should be reported separately from other inventory in the consignor's financial statements as "inventory consigned to others" or another appropriate caption.

3. Delivery and Performance

Question 3

Facts: Company A receives purchase orders for products it manufactures. At the end of its fiscal quarters, customers may not yet be ready to take delivery of the products for various reasons. These reasons may include, but are not limited to, a lack of available space for inventory, having more than sufficient inventory in their distribution channel, or delays in customers' production schedules.

Question: May Company A recognize revenue for the sale of its products once it has completed manufacturing if it segregates the inventory of the products in its own warehouse from its own products?

May Company A recognize revenue for the sale if it ships the products to a third-party warehouse but (1) Company A retains title to the product and (2) payment by the customer is dependent upon ultimate delivery to a customer-specified site?

Interpretative Response: Generally, no. The staff believes that delivery generally is not considered to have occurred unless the customer has taken title and assumed the risks and rewards of ownership of the products specified in the customer's purchase order or sales agreement. Typically this occurs when a product is delivered to the customer's delivery site (if the terms of the sale are "FOB destination") or when a product is shipped to the customer (if the terms are "FOB shipping point").

The Commission has set forth criteria to be met in order to recognize revenue when delivery has not occurred.¹ These include:

1. The risks of ownership must have passed to the buyer;
2. The customer must have made a fixed commitment to purchase the goods, preferably in written documentation;
3. The buyer, not the seller, must request that the transaction be on a bill and hold basis.² The buyer must have a

substantial business purpose for ordering the goods on a bill and hold basis;

4. There must be a fixed schedule for delivery of the goods. The date for delivery must be reasonable and must be consistent with the buyer's business purpose (e.g., storage periods are customary in the industry);

5. The seller must not have retained any specific performance obligations such that the earning process is not complete;

6. The ordered goods must have been segregated from the seller's inventory and not be subject to being used to fill other orders; and

7. The equipment [product] must be complete and ready for shipment.

The above listed conditions are the important conceptual criteria which should be used in evaluating any purported bill and hold sale. This listing is not intended as a checklist. In some circumstances, a transaction may meet all factors listed above but not meet the requirements for revenue recognition. The Commission also has noted that in applying the above criteria to a purported bill and hold sale, the individuals responsible for the preparation and filing of financial statements also should consider the following factors:³

1. The date by which the seller expects payment, and whether the seller has modified its normal billing and credit terms for this buyer;⁴

2. The seller's past experiences with and pattern of bill and hold transactions;

3. Whether the buyer has the expected risk of loss in the event of a decline in the market value of goods;

4. Whether the seller's custodial risks are insurable and insured;

5. Whether extended procedures are necessary in order to assure that there are no exceptions to the buyer's commitment to accept and pay for the goods sold (i.e., that the business reasons for the bill and hold have not introduced a contingency to the buyer's commitment).

Delivery generally is not considered to have occurred unless the product has been delivered to the customer's place of business or another site specified by the customer. If the customer specifies

an intermediate site but a substantial portion of the sales price is not payable until delivery is made to a final site, then revenue should not be recognized until final delivery has occurred.⁵

After delivery of a product or performance of a service, if uncertainty exists about customer acceptance, revenue should not be recognized until acceptance occurs.⁶ Customer acceptance provisions may be included in a contract, among other reasons, to enforce a customer's rights to (1) test the delivered product, (2) require the seller to perform additional services subsequent to delivery of an initial product or performance of an initial service (e.g., a seller is required to install or activate delivered equipment), or (3) identify other work necessary to be done before accepting the product. The staff presumes that such contractual customer acceptance provisions are substantive, bargained-for terms of an arrangement. Accordingly, when such contractual customer acceptance provisions exist, the staff generally believes that the seller should not recognize revenue until customer acceptance occurs or the acceptance provisions lapse.

A seller should substantially complete or fulfill the terms specified in the arrangement in order for delivery or performance to have occurred.⁷ When applying the substantially complete notion, the staff believes that only inconsequential or perfunctory actions may remain incomplete such that the failure to complete the actions would not result in the customer receiving a refund or rejecting the delivered products or services performed to date. In addition, the seller should have a demonstrated history of completing the remaining tasks in a timely manner and reliably estimating the remaining costs. If revenue is recognized upon substantial completion of the arrangement, all remaining costs of performance or delivery should be accrued.

⁵ SOP 97-2, paragraph 22.

⁶ SOP 97-2 paragraph 20. Also, Concepts Statement 5, paragraph 83(b) states "revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues." If an arrangement expressly requires customer acceptance, the staff generally believes that customer acceptance should occur before the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues, especially when the seller is obligated to perform additional steps.

⁷ Concepts Statement 5, paragraph 83(b) states that "revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues."

¹ See In the Matter of Stewart Parness, AAER Release 108 (August 5, 1986); *SEC v. Bollinger Industries, Inc., et al*, Lit. Rel 15093 (September 30, 1996); In the Matter of Laser Photonics, Inc., AAER 971 (September 30, 1997); In the Matter of Cypress Bioscience, Inc., AAER 817 (September 19, 1996). Also see Concepts Statement 5, paragraph 84(a) and SOP 97-2, paragraph 22.

² Such requests typically should be set forth in writing by the buyer.

³ See Note 1, *supra*.

⁴ Such individuals should consider whether Opinion 21 pertaining to the need for discounting the related receivable, is applicable. Opinion 21, paragraph 3(a), indicates that the requirements of that Opinion to record receivables at a discounted value are not intended to apply to "receivables and payables arising from transactions with customers or suppliers in the normal course of business which are due in customary trade terms not exceeding approximately one year" (emphasis added).

If an arrangement (*i.e.*, outside the scope of SOP 81–1) requires the delivery or performance of multiple deliverables, or “elements,” the existence of undelivered elements may affect the conclusion as to whether revenue for a delivered element may be recognized as discussed in EITF Issue 00–21.⁸

In licensing and similar arrangements (*e.g.*, licenses of motion pictures, software, technology, and other intangibles), the staff believes that delivery does not occur for revenue recognition purposes until the license term begins.⁹ Accordingly, if a licensed product or technology is physically delivered to the customer, but the license term has not yet begun, revenue should not be recognized prior to inception of the license term. Upon inception of the license term, revenue should be recognized in a manner

⁸ Paragraph 4 of EITF Issue 00–21 describes the scope of that consensus. As of the January 23, 2003 of the EITF (the EITF subsequently established a working group to revisit the scope of the consensus; accordingly, registrants should consult the current EITF Abstract for the final resolution of the scope of the consensus), paragraph 4 states that “This Issue applies to all deliverables (that is, products, services, or rights to use assets) within contractually binding arrangements (whether written, oral, or implied, and hereinafter referred to as “arrangements;”) in all industries under which a vendor will perform multiple revenue-generating activities, except as follows:

a. To the extent that a deliverable(s) in an arrangement is within the scope of other existing higher-level authoritative literature that provides guidance on whether and/or how to separate multiple-deliverable arrangements and how to allocate value among those separate units of accounting (including, but not limited to, Statements 13, 45, and 66; Technical Bulletin 90–1; and SOPs 81–1, 997–2, and 00–2), that deliverable(s) should be accounted for in accordance with that literature. However, if that arrangement also includes a deliverable(s) that is *not* within the scope of such higher-level literature, this Issue should be applied to determine (1) whether that deliverable(s) represents a separate unit of accounting from the deliverable(s) that is within the scope of other higher-level literature and, if so, (2) how to allocate the arrangement consideration to the separate units of accounting, unless the higher-level literature provides guidance with respect to (1) or (2), above, for the deliverable(s) that is not otherwise in the scope of the higher-level literature. The literature to be applied first is that which is applicable to the first delivered item(s).

b. Arrangements that include vendor offers to a customer for either (1) free or discounted products or services that will be delivered (either by the vendor or by another unrelated entity) at a future date if the customer completes a specified cumulative level of revenue transactions with the vendor or remains a customer of the vendor for a specified time period or (2) a rebate or refund of a determinable cash amount if the customer completes a specified cumulative level of revenue transactions with the vendor or remains a customer of the vendor for a specified time period, are excluded from the scope of this Issue. Additionally, arrangements involving the sale of award credits by broad-based loyalty program operators are excluded from the scope of this Issue.”

⁹ SOP 00–2, paragraph 7.

consistent with the nature of the transaction and the earnings process.

Question 4

Facts: Company R is a retailer that offers “layaway” sales to its customers. Company R retains the merchandise, sets it aside in its inventory, and collects a cash deposit from the customer. Although Company R may set a time period within which the customer must finalize the purchase, Company R does not require the customer to enter into an installment note or other fixed payment commitment or agreement when the initial deposit is received. The merchandise generally is not released to the customer until the customer pays the full purchase price. In the event that the customer fails to pay the remaining purchase price, the customer forfeits its cash deposit. In the event the merchandise is lost, damaged, or destroyed, Company R either must refund the cash deposit to the customer or provide replacement merchandise.

Question: In the staff’s view, when may Company R recognize revenue for merchandise sold under its layaway program?

Interpretive Response: Provided that the other criteria for revenue recognition are met, the staff believes that Company R should recognize revenue from sales made under its layaway program upon delivery of the merchandise to the customer. Until then, the amount of cash received should be recognized as a liability entitled such as “deposits received from customers for layaway sales” or a similarly descriptive caption. Because Company R retains the risks of ownership of the merchandise, receives only a deposit from the customer, and does not have an enforceable right to the remainder of the purchase price, the staff would object to Company R recognizing any revenue upon receipt of the cash deposit. This is consistent with item two (2) in the Commission’s criteria for bill-and-hold transactions which states that “the customer must have made a fixed commitment to purchase the goods.”

Question 5

Facts: Registrants may negotiate arrangements pursuant to which they may receive nonrefundable fees upon entering into arrangements or on certain specified dates. The fees may ostensibly be received for conveyance of a license or other intangible right or for delivery of particular products or services. Various business factors may influence how the registrant and customer structure the payment terms. For example, in exchange for a greater up-front fee for an intangible right, the registrant may be willing to receive

lower unit prices for related products to be delivered in the future. In some circumstances, the right, product, or service conveyed in conjunction with the nonrefundable fee has no utility to the purchaser separate and independent of the registrant’s performance of the other elements of the arrangement. Therefore, in the absence of the registrant’s continuing involvement under the arrangement, the customer would not have paid the fee. Examples of this type of arrangement include the following:

- A registrant sells a lifetime membership in a health club. After paying a nonrefundable “initiation fee,” the customer is permitted to use the health club indefinitely, so long as the customer also pays an additional usage fee each month. The monthly usage fees collected from all customers are adequate to cover the operating costs of the health club.

- A registrant in the biotechnology industry agrees to provide research and development activities for a customer for a specified term. The customer needs to use certain technology owned by the registrant for use in the research and development activities. The technology is not sold or licensed separately without the research and development activities. Under the terms of the arrangement, the customer is required to pay a nonrefundable “technology access fee” in addition to periodic payments for research and development activities over the term of the contract.

- A registrant requires a customer to pay a nonrefundable “activation fee” when entering into an arrangement to provide telecommunications services. The terms of the arrangement require the customer to pay a monthly usage fee that is adequate to recover the registrant’s operating costs. The costs incurred to activate the telecommunications service are nominal.

Question: When should the revenue relating to nonrefundable, up-front fees in these types of arrangements be recognized?

Interpretive Response: The staff believes that registrants should consider the specific facts and circumstances to determine the appropriate accounting for nonrefundable, up-front fees. Unless the up-front fee is in exchange for products delivered or services performed that represent the culmination of a separate earnings process,¹⁰ the deferral of revenue is appropriate.

¹⁰ See Concepts Statement 5, footnote 51, for a description of the “earning process.”

In the situations described above, the staff does not view the activities completed by the registrants (*i.e.*, selling the membership, signing the contract, or enrolling the customer or activating telecommunications services) as discrete earnings events.¹¹ The terms, conditions, and amounts of these fees typically are negotiated in conjunction with the pricing of all the elements of the arrangement, and the customer would ascribe a significantly lower, and perhaps no, value to elements ostensibly associated with the up-front fee in the absence of the registrant's performance of other contract elements. The fact that the registrants do not sell the initial rights, products, or services separately (*i.e.*, without the registrants' continuing involvement) supports the staff's view. The staff believes that the customers are purchasing the on-going rights, products, or services being provided through the registrants' continuing involvement. Further, the staff believes that the earnings process is completed by performing under the terms of the arrangements, not simply by originating a revenue-generating arrangement.

Supply or service transactions may involve the charge of a nonrefundable initial fee with subsequent periodic payments for future products or services. The initial fees may, in substance, be wholly or partly an advance payment for future products or services. In the examples above, the on-going rights or services being provided or products being delivered are essential to the customers receiving the expected benefit of the up-front payment. Therefore, the up-front fee and the continuing performance obligation related to the services to be provided or products to be delivered are assessed as an integrated package. In such circumstances, the staff believes that up-front fees, even if nonrefundable, are earned as the products and/or services are delivered and/or performed over the term of the arrangement or the expected period of performance¹² and generally should be deferred and recognized

systematically over the periods that the fees are earned.¹³

Question 6

Facts: Company A provides its customers with activity tracking or similar services (*e.g.*, tracking of property tax payment activity, sending delinquency letters on overdue accounts, etc.) for a ten-year period. Company A requires customers to prepay for all the services for the term specified in the arrangement. The on-going services to be provided are generally automated after the initial customer set-up. At the outset of the arrangement, Company A performs set-up procedures to facilitate delivery of its on-going services to the customers.¹⁴ Such procedures consist primarily of establishing the necessary records and files in Company A's pre-existing computer systems in order to provide the services. Once the initial customer set-up activities are complete, Company A provides its services in accordance with the arrangement. Company A is not required to refund any portion of the fee if the customer terminates the services or does not utilize all of the services to which it is entitled. However, Company A is required to provide a refund if Company A terminates the arrangement early. Assume Company A's activities are not within the scope of Statement 91.

Question: When should Company A recognize the service revenue?

Interpretive Response: The staff believes that, provided all other revenue recognition criteria are met, service revenue should be recognized on a straight-line basis, unless evidence suggests that the revenue is earned or obligations are fulfilled in a different pattern, over the contractual term of the arrangement or the expected period during which those specified services

will be performed,¹⁵ whichever is longer. In this case, the customer contracted for the on-going activity tracking service, not for the set-up activities. The staff notes that the customer could not, and would not, separately purchase the set-up services without the on-going services. The services specified in the arrangement are performed continuously over the contractual term of the arrangement (and any subsequent renewals). Therefore, the staff believes that Company A should recognize revenue on a straight-line basis, unless evidence suggests that the revenue is earned or obligations are fulfilled in a different pattern, over the contractual term of the arrangement or the expected period during which those specified services will be performed, whichever is longer.

In this situation, the staff would object to Company A recognizing revenue in proportion to the costs incurred because the set-up costs incurred bear no direct relationship to the performance of services specified in the arrangement. The staff also believes that it is inappropriate to recognize the entire amount of the prepayment as revenue at the outset of the arrangement by accruing the remaining costs because the services required by the contract have not been performed.

4. Fixed or Determinable Sales Price

A company's contracts may include customer cancellation or termination clauses. Cancellation or termination provisions may be indicative of a demonstration period or an otherwise incomplete transaction. Examples of transactions that financial management and auditors should be aware of and where such provisions may exist include "side" agreements and significant transactions with unusual terms and conditions. These contractual provisions raise questions as to whether the sales price is fixed or determinable. The sales price in arrangements that are cancelable by the customer are neither fixed nor determinable until the cancellation privileges lapse.¹ If the cancellation privileges expire ratably over a stated contractual term, the sales price is considered to become determinable ratably over the stated term.² Short-term rights of return, such as thirty-day money-back guarantees, and other customary rights to return products are not considered to be cancellation privileges, but should be

¹¹ In a similar situation, lenders may collect nonrefundable loan origination fees in connection with lending activities. The FASB concluded in Statement 91 that loan origination is not a separate revenue-producing activity of a lender, and therefore, those nonrefundable fees collected at the outset of the loan arrangement are not recognized as revenue upon receipt but are deferred and recognized over the life of the loan (paragraphs 5 and 37).

¹² The revenue recognition period should extend beyond the initial contractual period if the relationship with the customer is expected to extend beyond the initial term and the customer continues to benefit from the payment of the up-front fee (*e.g.*, if subsequent renewals are priced at a bargain to the initial up-front fee).

¹³ A systematic method would be on a straight-line basis, unless evidence suggests that revenue is earned or obligations are fulfilled in a different pattern, in which case that pattern should be followed.

¹⁴ Footnote 1 of SOP 98-5 states that "this SOP does not address the financial reporting of costs incurred related to ongoing customer acquisition, such as policy acquisition costs in Statement 60 * * * and loan origination costs in Statement 91 * * *. The SOP addresses the more substantive one-time efforts to establish business with an entirely new class of customers (for example, a manufacturer who does all of its business with retailers attempts to sell merchandise directly to the public)." As such, the set-up costs incurred in this example are not within the scope of SOP 98-5. The staff believes that the incremental direct costs (Statement 91 provides an analogous definition) incurred related to the acquisition or origination of a customer contract, unless specifically provided for in the authoritative literature, should be accounted for in accordance with paragraph 4 of Technical Bulletin 90-1 or paragraph 5 of Statement 91.

¹⁵ See Note 12, *supra*.

¹ SOP 97-2, paragraph 31.

² *Ibid*.

accounted for in accordance with Statement 48.³

Question 7

Facts: Company M is a discount retailer. It generates revenue from annual membership fees it charges customers to shop at its stores and from the sale of products at a discount price to those customers. The membership arrangements with retail customers require the customer to pay the entire membership fee (e.g., \$35) at the outset of the arrangement. However, the customer has the unilateral right to cancel the arrangement at any time during its term and receive a full refund of the initial fee. Based on historical data collected over time for a large number of homogeneous transactions, Company M estimates that approximately 40% of the customers will request a refund before the end of the membership contract term. Company M's data for the past five years indicates that significant variations between actual and estimated cancellations have not occurred, and Company M does not expect significant variations to occur in the foreseeable future.

Question: May Company M recognize in earnings the revenue for the membership fees and accrue the costs to provide membership services at the outset of the arrangement?

Interpretive Response: No. In the staff's view, it would be inappropriate for Company M to recognize the membership fees as earned revenue upon billing or receipt of the initial fee with a corresponding accrual for estimated costs to provide the membership services. This conclusion is based on Company M's remaining and unfulfilled contractual obligation to perform services (i.e., make available and offer products for sale at a discounted price) throughout the membership period. Therefore, the earnings process, irrespective of whether a cancellation clause exists, is not complete.

In addition, the ability of the member to receive a full refund of the membership fee up to the last day of the membership term raises an uncertainty as to whether the fee is fixed or determinable at any point before the end of the term. Generally, the staff believes that a sales price is not fixed or determinable when a customer has the unilateral right to terminate or cancel the contract and receive a cash refund. A sales price or fee that is variable until the occurrence of future events (other than product returns that are within the scope of Statement 48) generally is not

fixed or determinable until the future event occurs. The revenue from such transactions should not be recognized in earnings until the sales price or fee becomes fixed or determinable. Moreover, revenue should not be recognized in earnings by assessing the probability that significant, but unfulfilled, terms of a contract will be fulfilled at some point in the future. Accordingly, the revenue from such transactions should not be recognized in earnings prior to the refund privileges expiring. The amounts received from customers or subscribers (i.e., the \$35 fee mentioned above) should be credited to a monetary liability account such as "customers' refundable fees."

The staff believes that if a customer has the unilateral right to receive both (1) the seller's substantial performance under an arrangement (e.g., providing services or delivering product) and (2) a cash refund of prepaid fees, then the prepaid fees should be accounted for as a monetary liability. In consideration of whether the monetary liability can be derecognized, Statement 140 provides that liabilities may be derecognized only if (1) the debtor pays the creditor and is relieved of its obligation for the liability (paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities) or (2) the debtor is legally released from being the primary obligor under the liability.⁴ If a customer has the unilateral right to receive both (1) the seller's substantial performance under the arrangement and (2) a cash refund of prepaid fees, then the refund obligation is not relieved upon performance of the service or delivery of the products. Rather, the seller's refund obligation is relieved only upon refunding the cash or expiration of the refund privilege.

Some have argued that there may be a limited exception to the general rule that revenue from membership or other service transaction fees should not be recognized in earnings prior to the refund privileges expiring. Despite the fact that Statement 48 expressly does not apply to the accounting for service revenue if part or all of the service fee is refundable under cancellation privileges granted to the buyer,⁵ they believe that in certain circumstances a potential refund of a membership fee may be seen as being similar to a right of return of products under Statement 48. They argue that revenue from membership fees, net of estimated refunds, may be recognized ratably over the period the services are performed

whenever pertinent conditions of Statement 48 are met, namely, there is a large population of transactions that grant customers the same unilateral termination or cancellation rights and reasonable estimates can be made of how many customers likely will exercise those rights.

The staff believes that, because service arrangements are specifically excluded from the scope of Statement 48, the most direct authoritative literature to be applied to the extinguishment of obligations under such contracts is Statement 140. As noted above, because the refund privilege extends to the end of the contract term irrespective of the amount of the service performed, Statement 140 indicates that the liability would not be extinguished (and therefore no revenue would be recognized in earnings) until the cancellation or termination and related refund privileges expire. Nonetheless, the staff recognizes that over the years the accounting for membership refunds evolved based on analogy to Statement 48 and that practice did not change when Statement 140 became effective. Reasonable people held, and continue to hold, different views about the application of the accounting literature. For the staff to prohibit such accounting in this SAB may result in significant change in practice that, in these particular circumstances, may be more appropriately addressed in a formal rulemaking or standards-setting project.

Pending further action in this area by the FASB, the staff will not object to the recognition of refundable membership fees, net of estimated refunds, as earned revenue over the membership term in the limited circumstances where all of the following criteria have been met:⁶

- The estimates of terminations or cancellations and refunded revenues are being made for a large pool of homogeneous items (e.g., membership or other service transactions with the same characteristics such as terms, periods, class of customers, nature of service, etc.).
 - Reliable estimates of the expected refunds can be made on a timely basis.⁷
- Either of the following two items would be considered indicative of an inability to make reliable estimates: (1) recurring,

⁶ The staff will question further analogies to the guidance in Statement 48 for transactions expressly excluded from its scope.

⁷ Reliability is defined in Concepts Statement 2 as "the quality of information that assures that information is reasonably free from error and bias and faithfully represents what it purports to represent." Paragraph 63 of Concepts Statement 5 reiterates the definition of reliability, requiring that "the information is representationally faithful, verifiable, and neutral."

³ *Ibid.*

⁴ Statement 140, paragraph 16.

⁵ Statement 48, paragraph 4.

significant differences between actual experience and estimated cancellation or termination rates (*e.g.*, an actual cancellation rate of 40% versus an estimated rate of 25%) even if the impact of the difference on the amount of estimated refunds is not material to the consolidated financial statements⁸ or (2) recurring variances between the actual and estimated amount of refunds that are material to either revenue or net income in quarterly or annual financial statements. In addition, the staff believes that an estimate, for purposes of meeting this criterion, would not be reliable unless it is remote⁹ that material adjustments (both individually and in the aggregate) to previously recognized revenue would be required. The staff presumes that reliable estimates cannot be made if the customer's termination or cancellation and refund privileges exceed one year.

- There is a sufficient company-specific historical basis upon which to estimate the refunds,¹⁰ and the company believes that such historical experience is predictive of future events. In assessing these items, the staff believes that estimates of future refunds should take into consideration, among other things, such factors as historical experience by service type and class of customer, changing trends in historical experience and the basis thereof (*e.g.*, economic conditions), the impact or introduction of competing services or products, and changes in the customer's "accessibility" to the refund (*i.e.*, how easy it is for customers to obtain the refund).

- The amount of the membership fee specified in the agreement at the outset of the arrangement is fixed, other than the customer's right to request a refund.

If Company M does not meet all of the foregoing criteria, the staff believes that Company M should not recognize in earnings any revenue for the membership fee until the cancellation privileges and refund rights expire.

⁸ For example, if an estimate of the expected cancellation rate varies from the actual cancellation rate by 100% but the dollar amount of the error is immaterial to the consolidated financial statements, some would argue that the estimate could still be viewed as reliable. The staff disagrees with that argument.

⁹ The term "remote" is used here with the same definition as used in Statement 5.

¹⁰ Paragraph 8 of Statement 48 notes various factors that may impair the ability to make a reasonable estimate of returns, including the lack of sufficient historical experience. The staff typically expects that the historical experience be based on the particular registrant's historical experience for a service and/or class of customer. In general, the staff typically expects a start-up company, a company introducing new services, or a company introducing services to a new class of customer to have at least two years of experience to be able to make reasonable and reliable estimates.

If revenue is recognized in earnings over the membership period pursuant to the above criteria, the initial amounts received from customer or subscribers (*i.e.*, the \$35 fee mentioned above) should be allocated to two liability accounts. The amount of the fee representing estimated refunds should be credited to a monetary liability account, such as "customers' refundable fees," and the remaining amount of the fee representing unearned revenue should be credited to a nonmonetary liability account, such as "unearned revenues." For each income statement presented, registrants should disclose in the footnotes to the financial statements the amounts of (1) the unearned revenue and (2) refund obligations as of the beginning of each period, the amount of cash received from customers, the amount of revenue recognized in earnings, the amount of refunds paid, other adjustments (with an explanation thereof), and the ending balance of (1) unearned revenue and (2) refund obligations.

If revenue is recognized in earnings over the membership period pursuant to the above criteria, the staff believes that adjustments for changes in estimated refunds should be recorded using a retrospective approach whereby the unearned revenue and refund obligations are remeasured and adjusted at each balance sheet date with the offset being recorded as earned revenue.

Companies offering memberships often distribute membership packets describing and discussing the terms, conditions, and benefits of membership. Packets may include vouchers, for example, that provide new members with discounts or other benefits. The costs associated with the vouchers should be expensed when distributed. Advertising costs to solicit members should be accounted for in accordance with SOP 93-7. Incremental direct costs incurred in connection with enrolling customers (*e.g.*, commissions paid to agents) should be accounted for as follows: (1) If revenue is deferred until the cancellation or termination privileges expire, incremental direct costs should be either (a) charged to expense when incurred if the costs are not refundable to the company in the event the customer obtains a refund of the membership fee, or (b) if the costs are refundable to the company in the event the customer obtains a refund of the membership fee, recorded as an asset until the earlier of termination or cancellation or refund; or (2) if revenue, net of estimated refunds, is recognized in earnings over the membership period, a like percentage of incremental direct costs should be deferred and recognized

in earnings in the same pattern as revenue is recognized, and the remaining portion should be either (a) charged to expense when incurred if the costs are not refundable to the company in the event the customer obtains a refund of the membership fee, or (b) if the costs are refundable to the company in the event the customer obtains a refund of the membership fee, recorded as an asset until the refund occurs.¹¹ All costs other than incremental direct costs (*e.g.*, indirect costs) should be expensed as incurred.

Question 8

Facts: Company A owns and leases retail space to retailers. Company A (lessor) renews a lease with a customer (lessee) that is classified as an operating lease. The lease term is one year and provides that the lease payments are \$1.2 million, payable in equal monthly installments on the first day of each month, plus one percent of the lessee's net sales in excess of \$25 million if the net sales exceed \$25 million during the lease term (*i.e.*, contingent rental). The lessee has historically experienced annual net sales in excess of \$25 million in the particular space being leased, and it is probable that the lessee will generate in excess of \$25 million net sales during the term of the lease.

Question: In the staff's view, should the lessor recognize any rental income attributable to the one percent of the lessee's net sales exceeding \$25 million before the lessee actually achieves the \$25 million net sales threshold?

Interpretive Response: No. The staff believes that contingent rental income "accrues" (*i.e.*, it should be recognized as revenue) when the changes in the factor(s) on which the contingent lease payments is (are) based actually occur.¹²

Statement 13 paragraph 19(b) states that lessors should account for operating leases as follows: "Rent shall be reported in income over the lease term as it becomes receivable according to the provisions of the lease. However, if the rentals vary from a straight-line basis, the income shall be recognized on a straight-line basis unless another systematic and rational basis is more

¹¹ Statement 91, paragraph 5 and Technical Bulletin 90-1, paragraph 4 both provide for the deferral of incremental direct costs associated with acquiring a revenue-producing contract. Even though the revenue discussed in this example is refundable, if a registrant meets the aforementioned criteria for revenue recognition over the membership period, the staff would analogize to this guidance. However, if neither a nonrefundable contract nor a reliable basis for estimating net cash inflows under refundable contracts exists to provide a basis for recovery of incremental direct costs, the staff believes that such costs should be expensed as incurred. See Note 14 of SAB Topic 13.A.3.

¹² Lessees should follow the guidance established in EITF Issue 98-9.

representative of the time pattern in which use benefit from the leased property is diminished, in which case that basis shall be used.”

Statement 29 amended Statement 13 and clarifies that “lease payments that depend on a factor that does not exist or is not measurable at the inception of the lease, such as future sales volume, would be contingent rentals in their entirety and, accordingly, would be excluded from minimum lease payments and included in the determination of income as they accrue.” [Summary] Paragraph 17 of Statement 29 provides the following example of determining contingent rentals:

A lease agreement for retail store space could stipulate a monthly base rental of \$200 and a monthly supplemental rental of one-fourth of one percent of monthly sales volume during the lease term. Even if the lease agreement is a renewal for store space that had averaged monthly sales of \$25,000 for the past 2 years, minimum lease payments would include only the \$200 monthly base rental; the supplemental rental is a contingent rental that is excluded from minimum lease payments. The future sales for the lease term do not exist at the inception of the lease, and future rentals would be limited to \$200 per month if the store were subsequently closed and no sales were made thereafter.

Technical Bulletin 85-3 addresses whether it is appropriate for lessors in operating leases to recognize scheduled rent increases on a basis other than as required in Statement 13, paragraph 19(b). Paragraph 2 of Technical Bulletin 85-3 states “using factors such as the time value of money, anticipated inflation, or *expected future revenues* [emphasis added] to allocate scheduled rent increases is inappropriate because these factors do not relate to the *time pattern* of the physical usage of the leased property. However, such factors may affect the periodic reported rental income or expense if the lease agreement involves contingent rentals, which are excluded from minimum lease payments and accounted for separately under Statement 13, as amended by Statement 29.” In developing the basis for why scheduled rent increases should be recognized on a straight-line basis, the FASB distinguishes the accounting for scheduled rent increases from contingent rentals. Paragraph 13 states “There is an important substantive difference between lease rentals that are contingent upon some specified future event and scheduled rent increases that are unaffected by future events; the accounting under Statement 13 reflects that difference. If the lessor and lessee eliminate the risk of variable payments

by agreeing to scheduled rent increases, the accounting should reflect those different circumstances.”

The example provided in Statement 29 implies that contingent rental income in leases classified as sales-type or direct-financing leases becomes “accruable” when the changes in the factors on which the contingent lease payments are based actually occur. Technical Bulletin 85-3 indicates that contingent rental income in operating leases should not be recognized in a manner consistent with scheduled rent increases (*i.e.*, on a straight-line basis over the lease term or another systematic and rational allocation basis if it is more representative of the time pattern in which the leased property is physically employed) because the risk of variable payments inherent in contingent rentals is substantively different than scheduled rent increases. The staff believes that the reasoning in Technical Bulletin 85-3 supports the conclusion that the risks inherent in variable payments associated with contingent rentals should be reflected in financial statements on a basis different than rental payments that adjust on a scheduled basis and, therefore, operating lease income associated with contingent rents would not be recognized as time passes or as the leased property is physically employed. Furthermore, prior to the lessee’s achievement of the target upon which contingent rentals are based, the lessor has no legal claims on the contingent amounts. Consequently, the staff believes that it is inappropriate to anticipate changes in the factors on which contingent rental income in operating leases is based and recognize rental income prior to the resolution of the lease contingencies.

Because Company A’s contingent rental income is based upon whether the customer achieves net sales of \$25 million, the contingent rentals, which may not materialize, should not be recognized until the customer’s net sales actually exceed \$25 million. Once the \$25 million threshold is met, Company A would recognize the contingent rental income as it becomes accruable, in this case, as the customer recognizes net sales. The staff does not believe that it is appropriate to recognize revenue based upon the probability of a factor being achieved. The contingent revenue should be recorded in the period in which the contingency is resolved.

Question 9

Facts: Paragraph 8 of Statement 48 lists a number of factors that may impair the ability to make a reasonable estimate of product returns in sales transactions

when a right of return exists.¹³ The paragraph concludes by stating “other factors may preclude a reasonable estimate.”

Question: What “other factors,” in addition to those listed in paragraph 8 of Statement 48, has the staff identified that may preclude a registrant from making a reasonable and reliable estimate of product returns?

Interpretive Response: The staff believes that the following additional factors, among others, may affect or preclude the ability to make reasonable and reliable estimates of product returns: (1) Significant increases in or excess levels of inventory in a distribution channel (sometimes referred to as “channel stuffing”), (2) lack of “visibility” into or the inability to determine or observe the levels of inventory in a distribution channel and the current level of sales to end users, (3) expected introductions of new products that may result in the technological obsolescence of and larger than expected returns of current products, (4) the significance of a particular distributor to the registrant’s (or a reporting segment’s) business, sales and marketing, (5) the newness of a product, (6) the introduction of competitors’ products with superior technology or greater expected market acceptance, and other factors that affect market demand and changing trends in that demand for the registrant’s products. Registrants and their auditors should carefully analyze all factors, including trends in historical data, that may affect registrants’ ability to make reasonable and reliable estimates of product returns.

The staff reminds registrants that if a transaction fails to meet all of the conditions of paragraphs 6 and 8 in Statement 48, no revenue may be recognized until those conditions are subsequently met or the return privilege has substantially expired, whichever occurs first.¹⁴ Simply deferring recognition of the gross margin on the transaction is not appropriate.

5. Income Statement Presentation

Question 10

¹³ These factors include “(a) the susceptibility of the product to significant external factors, such as technological obsolescence or changes in demand, (b) relative long periods in which a particular product may be returned, (c) absence of historical experience with similar types of sales of similar products, or inability to apply such experience because of changing circumstances, for example, changes in the selling enterprise’s marketing policies and relationships with its customers, and (d) absence of a large volume of relatively homogeneous transactions.”

¹⁴ Statement 48, paragraph 6.

Facts: Company A operates an internet site from which it will sell Company T's products. Customers place their orders for the product by making a product selection directly from the internet site and providing a credit card number for the payment. Company A receives the order and authorization from the credit card company, and passes the order on to Company T. Company T ships the product directly to the customer. Company A does not take title to the product and has no risk of loss or other responsibility for the product. Company T is responsible for all product returns, defects, and disputed credit card charges. The product is typically sold for \$175 of which Company A receives \$25. In the event a credit card transaction is rejected, Company A loses its margin on the sale (i.e., the \$25).

Question: In the staff's view, should Company A report revenue on a gross basis as \$175 along with costs of sales of \$150 or on a net basis as \$25, similar to a commission?

Interpretive Response: Company A should report the revenue from the product on a net basis. In assessing whether revenue should be reported gross with separate display of cost of sales to arrive at gross profit or on a net basis, the staff considers whether the registrant:¹

1. Acts as principal in the transaction,
2. takes title to the products,
3. has risks and rewards of ownership, such as the risk of loss for collection, delivery, or returns, and
4. acts as an agent or broker (including performing services, in substance, as an agent or broker) with compensation on a commission or fee basis.²

If the company performs as an agent or broker without assuming the risks and rewards of ownership of the goods, sales should be reported on a net basis.

B. Disclosures

Question 1

Question: What disclosures are required with respect to the recognition of revenue?

Interpretive Response: A registrant should disclose its accounting policy for the recognition of revenue pursuant to Opinion 22. Paragraph 12 thereof states that "the disclosure should encompass important judgments as to appropriateness of principles relating to recognition of revenue * * *" Because

revenue recognition generally involves some level of judgment, the staff believes that a registrant should always disclose its revenue recognition policy. If a company has different policies for different types of revenue transactions, including barter sales, the policy for each material type of transaction should be disclosed. If sales transactions have multiple elements, such as a product and service, the accounting policy should clearly state the accounting policy for each element as well as how multiple elements are determined and valued. In addition, the staff believes that changes in estimated returns recognized in accordance with Statement 48 should be disclosed, if material (e.g., a change in estimate from two percent of sales to one percent of sales).

Regulation S-X requires that revenue from the sales of products, services, and other products each be separately disclosed on the face of the income statement.¹ The staff believes that costs relating to each type of revenue similarly should be reported separately on the face of the income statement.

MD&A requires a discussion of liquidity, capital resources, results of operations and other information necessary to an understanding of a registrant's financial condition, changes in financial condition and results of operations.² This includes unusual or infrequent transactions, known trends or uncertainties that have had, or might reasonably be expected to have, a favorable or unfavorable material effect on revenue, operating income or net income and the relationship between revenue and the costs of the revenue. Changes in revenue should not be evaluated solely in terms of volume and price changes, but should also include an analysis of the reasons and factors contributing to the increase or decrease. The Commission stated in FRR 36 that MD&A should "give investors an opportunity to look at the registrant through the eyes of management by providing a historical and prospective analysis of the registrant's financial condition and results of operations, with a particular emphasis on the registrant's prospects for the future."³ Examples of such revenue transactions or events that the staff has asked to be disclosed and discussed in accordance with FRR 36 are:

- Shipments of product at the end of a reporting period that significantly reduce customer backlog and that

reasonably might be expected to result in lower shipments and revenue in the next period.

- Granting of extended payment terms that will result in a longer collection period for accounts receivable (regardless of whether revenue has been recognized) and slower cash inflows from operations, and the effect on liquidity and capital resources. (The fair value of trade receivables should be disclosed in the footnotes to the financial statements when the fair value does not approximate the carrying amount.)⁴

- Changing trends in shipments into, and sales from, a sales channel or separate class of customer that could be expected to have a significant effect on future sales or sales returns.

- An increasing trend toward sales to a different class of customer, such as a reseller distribution channel that has a lower gross profit margin than existing sales that are principally made to end users. Also, increasing service revenue that has a higher profit margin than product sales.

- Seasonal trends or variations in sales.

- A gain or loss from the sale of an asset(s).⁵

Question 2

Question: Will the staff expect retroactive changes by registrants to comply with the accounting described in this bulletin?

Interpretive Response: All registrants are expected to apply the accounting and disclosures described in this bulletin. The staff, however, will not object if registrants that have not applied this accounting do not restate prior financial statements provided they report a change in accounting principle in accordance with Opinion 20 and Statement 3 no later than the fourth fiscal quarter of the fiscal year beginning after December 15, 1999. In periods subsequent to transition, registrants should disclose the amount of revenue (if material to income before income taxes) recognized in those periods that was included in the cumulative effect adjustment. If a registrant files financial statements with the Commission before applying the guidance in this bulletin, disclosures similar to those described in SAB Topic 11.M should be provided. With regard to question 10 of Topic 13.A and Topic 8.A regarding income statement presentation, the staff would normally expect retroactive application

⁴ Statement 107.

⁵ Gains or losses from the sale of assets should be reported as "other general expenses" pursuant to Regulation S-X, Article 5-03(b)(6). Any material item should be stated separately.

¹ Subsequent to the issuance of this SAB, the EITF provided additional guidance on gross vs. net presentation in Issue 99-19.

² See, for example, ARB 43, Chapter 11A, paragraph 20; SOP 81-1, paragraphs 58-60; and Statement 45, paragraph 16.

³ See Regulation S-X, Article 5-03(b)(1) and (2).

⁴ See Regulation S-K, Article 303 and FRR 36.

⁵ FRR 36, also see In the Matter of Caterpillar Inc., AAER 363 (March 31, 1992).

to all periods presented unless the effect of applying the guidance herein is immaterial.

However, if registrants have not previously complied with GAAP, for example, by recording revenue for products prior to delivery that did not comply with the applicable bill-and-hold guidance, those registrants should apply the guidance in Opinion 20 for

the correction of an error.⁶ In addition,

⁶ Opinion 20, paragraph 13 and paragraphs 36–37 describe and provide the accounting and disclosure requirements applicable to the correction of an error in previously issued financial statements. Because the term “error” as used in Opinion 20 includes “oversight or misuse of facts that existed at the time that the financial statements were prepared,” that term includes both unintentional errors as well as intentional fraudulent financial reporting and misappropriation of assets as described in SAS 99.

registrants should be aware that the Commission may take enforcement action where a registrant in prior financial statements has violated the antifraud or disclosure provisions of the securities laws with respect to revenue recognition.

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