

SMALL BUSINESS ADMINISTRATION**13 CFR Part 107****Small Business Investment Companies; Accounting and Financial Reporting Standards**

AGENCY: Small Business Administration.

ACTION: Interim final rule.

SUMMARY: The Small Business Administration (SBA) currently provides accounting guidance for Small Business Investment Companies (SBICs) in two appendices to SBA regulations. These appendices have not been significantly revised since 1986. Subsequent changes in generally accepted accounting principles and in the SBIC program have caused the accounting standards to become outdated and incomplete. This rule updates the standards for accounting and financial reporting by SBICs, as well as the guidelines for Independent Public Accountants (IPAs) performing audits of SBIC financial statements.

The current appendix I includes SBA Form 468, on which SBICs prepare the required Annual Financial Report to SBA. The current appendix II includes the standard chart of accounts for SBICs. This rule deletes both the Form 468 and the chart of accounts from the regulations and consolidates the remaining material in appendices I and II into one appendix.

DATES: This interim final rule is effective February 7, 1995. Written comments on this rule must be received no later than March 9, 1995.

ADDRESSES: Written comments should be sent to Robert D. Stillman, Associate Administrator for Investment, Small Business Administration, Suite 6300, 409 3rd Street SW., Washington, DC 20416.

FOR FURTHER INFORMATION CONTACT: Carol Fendler, Office of Program Support; telephone no. (202) 205-7559.

SUPPLEMENTARY INFORMATION: The accounting standards published by SBA on August 28, 1986 (51 FR 30752) have since undergone only minor revisions. As a result, these standards do not reflect subsequent changes in the SBIC program mandated by the Small Business Investment Act of 1958, as amended (Act), as well as changes in generally accepted accounting principles (GAAP).

This rule updates the accounting standards for the SBIC program, while also reorganizing the material to make information on specific topics easier to find. The accounting, financial reporting and auditing requirements included in

the current appendices I and II to Part 107 of SBA regulations are consolidated into a revised appendix I.

Two items currently included in the appendices are deleted: (1) The schedules which constitute SBA Form 468, on which SBICs prepare their Annual Financial Report to SBA, and (2) the standard SBIC chart of accounts. SBA is deleting Form 468 in the interest of consistency, since none of the other standard forms used in the SBIC program is included in Part 107 of the regulations or its appendices. The SBIC chart of accounts represents the type of explanatory material that SBA considers more appropriate for inclusion in a Policy and Procedural Release rather than in Agency regulations. SBA plans to provide updated versions of both the Form 468 and the SBIC chart of accounts after this rule is published. Until then, Licensees should continue to use the existing versions.

While many of the topics covered in this rule should be familiar to users of the current appendices, some are either new or significantly revised, including the following:

1. **Independent Auditors' Report**—Includes a sample report which satisfies current requirements of the American Institute of Certified Public Accountants.

2. **Access to Accountants' Working Papers**—States explicitly that SBA, in its discretion, may assign its examiners or other personnel to review accountants' working papers prepared in connection with audits of SBICs. Although this statement does not appear in the existing appendices, it is consistent with SBA's current position that working papers are subject to the requirements concerning records and reports set forth in § 107.1002 of the regulations.

3. **Accounting for Income Taxes**—Revised in accordance with FASB Statement No. 109, issued in February 1992, which sets forth current GAAP in this area.

4. **Interest Income**—Provides more specific guidance than before concerning the accounting treatment of delinquent interest. This section sets forth conditions which are deemed to create a presumption that the collection of interest is doubtful; SBICs would have the opportunity to rebut such a presumption. This approach is consistent with the valuation guidelines for interest-bearing securities published in the **Federal Register** on June 2, 1994 (59 FR 28471) and is intended to achieve greater consistency in financial reporting by SBICs.

5. **Undistributed Realized Earnings**—Provides more detailed definitions of

Undistributed Net Realized Earnings and Noncash Gains/Income, the two components of Undistributed Realized Earnings. These definitions are consistent with the interpretations currently used by SBA in practice.

6. **Retained Earnings Available for Distribution**—Corrects contradictory statements in the current appendices and provides additional detail concerning the computation of this amount, consistent with the definition of Retained Earnings Available for Distribution which was published in the **Federal Register** on April 8, 1994 (59 FR 16898).

7. **Preferred Securities Leverage for Section 301(d) Licensees**—Provides guidance on accounting for 4% redeemable preferred securities, a topic which is not addressed in the current appendices.

8. **Participating Securities**—Provides general guidance on financial statement presentation of these new equity-type securities, which may be issued by Licensees pursuant to the final rule published in the **Federal Register** on April 8, 1994. Additional guidance and computer software to perform the various profit and distribution computations associated with Participating Securities will be provided to issuers of such securities.

Compliance With Executive Orders 12866, 12612 and 12778, and the Regulatory Flexibility and Paperwork Reduction Acts

Executive Order 12866 and Regulatory Flexibility Act

This rule will not constitute a significant regulatory action for purposes of Executive Order 12866 because it is not likely to have an annual impact on the national economy of \$100 million or more, and, for purposes of the Regulatory Flexibility Act, 5 U.S.C. 601 *et seq.*, it will not have a substantial impact on a significant number of small entities.

1. The legal basis for this regulation is section 308(c) of the Small Business Investment Act, 15 U.S.C. 687(c).

2. The potential benefits of this regulation have been set forth in the discussion above, under Supplementary Information.

3. The potential cost of this regulation cannot be quantified or estimated.

4. There are no Federal rules which duplicate, overlap, or conflict with this rule.

5. SBA is not aware of regulatory alternatives that could achieve the same objectives at lower cost.

This rule was not reviewed under Executive Order 12866.

Executive Order 12612

SBA certifies that this regulation has no federalism implications warranting the preparation of a Federal Assessment in accordance with Executive Order 12612.

Paperwork Reduction Act

For purposes of the Paperwork Reduction Act, 44 U.S.C., ch. 35, SBA hereby certifies that this rule, in and of itself, will impose no new reporting or recordkeeping requirements. This rule prescribes the accounting treatment for certain types of financial transactions which are new to the SBIC program; such treatment, however, is dictated by the substance of these transactions, which has already been established by statute (primarily section 403 of Pub. L. 102-366).

Executive Order 12778

SBA certifies that this rule is drafted, to the extent practicable, in accordance with the standards set forth in Section 2 of Executive Order 12778.

SBA certifies pursuant to 5 U.S.C. 553(b)(B) that notice and comment in the promulgation of this regulation is impracticable. In this regard, the rule provides necessary accounting guidance to Licensees on recently implemented aspects of the SBIC program (such as Participating Securities and commitments from Institutional Investors). It also revises the guidelines to reflect recent regulatory changes in such areas as valuations, Retained Earnings Available for Distribution, and electronic reporting requirements. Licensees need to have access to this information in order to prepare their year end financial statements in a manner acceptable to SBA.

Other changes to the accounting guidelines are intended to bring them into compliance with generally accepted accounting principles. Some areas of the present guidelines (such as accounting for income taxes and preparation of the Independent Accountant's Report) are so out of date that they have become sources of significant confusion to Licensees.

Finally, this rule provides for the deletion of the present SBA Form 468 from the appendix to Part 107. This will allow SBA to implement a revised 468 (subject to OMB approval) for companies with fiscal years ending on or after December 31, 1994. The revised Form 468 is needed to accommodate reporting related to statutorily mandated programs, and also to provide Licensees with a format in which to show information such as economic impact data, investments in Smaller Concerns,

and computations of Regulatory and Leverageable Capital. Without the new Form 468, Licensees will find it difficult to report required financial information to SBA, and SBA will find it difficult to monitor key aspects of their financial condition and regulatory compliance.

Therefore, this rule is being promulgated as an interim final rule, and the public is offered an opportunity to comment on it subsequent to its publication. Comments will be taken into consideration in the ultimate finalization of the rule.

List of Subjects in 13 CFR Part 107

Investment companies, Loan programs—business, Small businesses.

For the reasons set forth above, Title 13, Part 107 of the Code of Federal Regulations is amended as follows:

PART 107—SMALL BUSINESS INVESTMENT COMPANIES

1. The authority citation for Part 107 continues to read as follows:

Authority: Title III of the Small Business Investment Act, 15 U.S.C. 681 *et seq.*; 15 U.S.C. 687c; 15 U.S.C. 683; 15 U.S.C. 687d; 15 U.S.C. 687g; 15 U.S.C. 687b; 15 U.S.C. 687m, as amended by Pub. L. 102-366.

2. Appendix I is revised to read as follows:

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I. Introduction

i. This appendix provides guidance to Small Business Investment Companies (SBICs) on accounting policies and procedures, financial reporting to SBA, and selection of an auditor. In addition, this appendix contains guidelines for Independent Public Accountants (IPAs) engaged to conduct annual audits of SBICs. This appendix is not intended to be a comprehensive treatment of all accounting and auditing issues which may arise in an SBIC; instead, its purpose is to cover those topics that are particularly relevant to the SBIC program and which may involve the application of specialized industry practices. Therefore, Licensees and their IPAs should consult other appropriate sources of information as needed. Furthermore, as in any audit, the independent auditor of an SBIC must exercise professional judgment as to the work required to satisfy generally accepted auditing standards.

ii. This appendix contains references to Securities and Exchange Commission (SEC) Rules and Regulations, pronouncements of the Financial Accounting Standards Board (FASB) and its predecessors, publications of the American Institute of Certified Public Accountants (AICPA), and the Internal Revenue Code. Such references are subject to change. It is the responsibility of the Licensee and its advisors to be aware of any regulatory, accounting, or tax code changes that could have an effect on the Licensee.

II. Recordkeeping and Financial Reporting**A. Records and Reports**

All books, records, ledgers, and other supporting documents shall be maintained in the English language. See § 107.1002 for specific requirements relating to the retention of records and the filing of reports with SBA.

B. Account Classification

i. Licensees shall maintain their books of account in accordance with the system of

account classification prescribed by SBA. The system has been prescribed to insure that standard books of account are maintained by Licensees and that uniform accounting policies are followed.

ii. Books of account for a management consulting or other subsidiary shall be maintained using accounts compatible with those used by the Licensee.

C. Annual Financial Report (SBA Form 468)

i. The Small Business Administration, under authority granted by the Small Business Investment Act of 1958, as amended (the Act), requires each Licensee to submit an Annual Financial Report as of the close of its fiscal year (see § 107.1002(e)). The Annual Financial Report consists of audited financial statements and supplementary schedules prepared on SBA Form 468, the Independent Public Accountant's report, the notes accompanying the financial statements, and the required certifications.

ii. Preparation of the Annual Financial Report is the responsibility of the Licensee. The Independent Public Accountant's responsibility is to perform an audit and to express an opinion on the financial statements and supplementary schedules based on the audit.

D. Filing of Annual Financial Report

i. The Annual Financial Report on SBA Form 468 shall be submitted to SBA by the Licensee no later than the last day of the third month following the end of the Licensee's fiscal year.

The Licensee shall include in its filing a copy of any transmittal letter, special report, or other communication furnished by its auditor.

ii. For all fiscal years ending on or after June 30, 1994, SBA Form 468 shall be submitted electronically, in accordance with § 107.101(h). All Licensees must use the electronic reporting software provided by SBA for this purpose. A complete filing of Form 468 consists of the following:

- (1) The electronic reporting data diskette;
- (2) Two printed copies of the financial statements and supplementary schedules;
- (3) The signed management certifications which appear on the last page of Form 468 (two copies, one with original signatures);
- (4) The IPA's report (two copies, one with original signature); and
- (5) The notes to the financial statements (two copies).

E. Portfolio Financing Report (SBA Form 1031)

For each financing of a small concern, Licensees shall submit a Portfolio Financing Report on SBA Form 1031 within 30 days of the closing date of the financing. Such reports shall be prepared using software provided by SBA. Licensees may submit a printout of the form to SBA or transmit it electronically. The report, which is used for program evaluation purposes, provides summary information concerning the amount and terms of the financing, the financial condition of the small concern and the intended use of proceeds, as well as information which will be used to assess the economic impact of the financing.

F. Interim Reports

SBA may require Licensees to submit interim reports containing unaudited financial and/or management information, pursuant to § 107.1002(g). The form and content of such reports may be standardized or determined by SBA on a case-by-case basis. Interim reports shall be submitted in such manner and at such time as SBA shall direct.

III. Selection and Qualification of the Auditor

A. Selection of the Auditor

i. The Licensee's Board of Directors or General Partner is responsible for selecting the Independent Public Accountant (IPA). Within 30 days of its engagement by the Licensee, the Independent Public Accountant shall file with the SBA a completed IPA Certification (CO Form 112) certifying as to its qualifications and independence. The IPA shall be deemed approved unless the Licensee is notified to the contrary by SBA within 90 days after receipt of the IPA Certification.

ii. Submittal of the IPA Certification is required only upon the initial engagement of the IPA. An IPA engaged to audit an SBIC on a recurring basis does not need to submit a new Certification each year.

iii. The Licensee shall notify the SBA in writing of a change in accountants and shall explain the reason for the change.

B. Qualification of the Auditor

Any Certified Public Accountant or Public Accountant, licensed by a regulatory authority of a State or other political subdivision of the United States, may be considered qualified to render an opinion on behalf of a Licensee, provided the following conditions are met: (1) The accountant is independent with respect to the Licensee, and (2) the accountant is duly authorized to practice and is in good standing under the laws of the State or other comparable authority in which so authorized.

C. Independence

i. Independent Public Accountants approved by SBA are to follow the Code of Professional Conduct adopted by the AICPA. In considering questions which may arise concerning the independence of an accountant with respect to a Licensee, the SBA will give appropriate consideration to all relevant circumstances, including evidence bearing on relationships between the accountant and such Licensee or any of its affiliates.

ii. Independence will be considered to be impaired by circumstances including, but not limited to, the following:

1. During the professional engagement, or at the time of expressing an opinion, the accountant or his/her firm:

a. Had or was committed to acquire any direct or indirect financial interest in the Licensee; or

b. Had any joint closely held business investment with the Licensee or any of its officers, directors or principal stockholders, or any general or limited partner, which was material in relation to the net worth of the accountant or his/her firm; or

c. Had any loan to or from the Licensee or any of its officers, directors or principal stockholders, or any general or limited partner.

2. During the period covered by the financial statements during the professional engagement, or at the time of expressing an opinion, the accountant or his/her firm:

a. Was connected with the Licensee as a promoter, underwriter, or voting trustee, a director of officer or in any capacity equivalent to that of a member of management or of an employee; or

b. Was a trustee of any trust or executor or administrator of any estate is such trust or estate had a direct or material indirect financial interest in the Licensee; or was a trustee for any pension or profit-sharing trust of the Licensee; or

c. Rendered bookkeeping services to the Licensee; *Provided however*, that SBA may approve the rendering of bookkeeping services by independent accountants on a case by case basis.

iii. Independent public accountants who audit Licensees which elect to qualify as Regulated Investment Companies should become familiar with Section 600 ("Matters Relating to Independent Accountants") of the SEC's "Codification of Financial Reporting Policies."

IV. Annual Audit

A. Generally Accepted Auditing Standards

The IPA shall perform an audit of the Licensee's financial statements in accordance with generally accepted auditing standards (GAAS) of the AICPA. It is the responsibility of accountants to be informed of any changes in GAAS as they occur. AICPA recommendations for the application of GAAS to audits of the financial statements of investment companies are presented in the publication, "Audits of Investment Companies", which is updated periodically. Although this publication deals primarily with companies investing in marketable securities, many of its recommended audit procedures are applicable to SBICs.

B. Independent Auditor's Report

i. The Independent Auditor's Report shall conform to current AICPA recommendations regarding the application of generally accepted auditing standards to reports on audited financial statements of investment companies. As of the publication date of these regulations, such recommendations are presented in chapter 9 of the AICPA publication, "Audits of Investment Companies." It is the responsibility of accountants to be aware of any changes in generally accepted auditing standards which may affect reporting requirements.

ii. The opinion expressed in the Independent Auditors' Report must refer specifically to the financial statements as they appear in SBA Form 468. An opinion expressed on financial statements prepared for general purposes, or for any specific purpose other than inclusion in SBA Form 468, is not acceptable. The financial statements may be listed by name in the auditor's report, or listed separately and referred to in the report (for example, the report could refer to the financial statements

“as listed on the following page” or “as listed in the accompanying index”).

iii. In addition to expressing an opinion on the basic financial statements (the statement of financial position, statement of operations realized and statement of cash flows), the accountant must express an opinion on the supplementary financial information. The supplementary information should be addressed in a separate paragraph of the Independent Auditors' Report. As with the basic financial statements, the supplementary statements and schedules may be listed in the report itself or listed separately and referred to in the report.

iv. Almost all SBICs have Loans and Investments, the value of which must be estimated by the Board of Directors or General Partner(s) in the absence of readily ascertainable market values. The auditor's reports for such SBICs must include an explanatory paragraph addressing portfolio valuations, in which the auditor states whether the valuation procedures are reasonable and the underlying documentation is appropriate. It is no longer acceptable to state that valuations involve subjective judgment which is not susceptible to substantiation by auditing procedures. The paragraph should follow the AICPA's reporting recommendations presented in chapter 9 of “Audits of Investment Companies”.

V. Sample Report. Following is a sample Independent Auditors' Report which is acceptable to SBA, based on generally accepted auditing standards in effect as of the publication date of these regulations. Any subsequent changes in generally accepted auditing standards which affect reporting requirements must be reflected in the Independent Auditors' Report included in a Licensee's filing of SBA Form 468, regardless of whether or not SBA has published an updated sample report.

Independent Auditors' Report

The Board of Directors of [Licensee]

or

The General Partner(s) and Limited Partners of [Licensee]

We have audited the statement of financial position of [Licensee] as of [closing date of fiscal year] and the related statements of operations realized and cash flows for the year then ended included in SBA Form 468. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of [Licensee] as of [closing date of fiscal year], and the results of its operations and cash flows for the year then ended in conformity with generally accepted accounting principles.

As explained in Note ____, the financial statements include investments valued at \$____ as of [closing date of fiscal year], whose values have been estimated by the [Board of Directors] [General Partner(s)], in the absence of readily ascertainable market values. We have reviewed the procedures used by the [Board of Directors] [General Partner(s)] in arriving at its estimates of value of such investments and have inspected underlying documentation, and, in the circumstances, we believe the procedures are reasonable and the documentation appropriate. However, because of the inherent uncertainty of valuation, those estimated values may differ significantly from the values that would have been used had a ready market for the investments existed, and the differences could be material.

Our audit was made for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplementary information contained in the [analysis of stockholders' equity] [analysis of partners' capital], computations of retained earnings available for distribution and of regulatory and leverageable capital, schedules of commitments and guarantees, and schedules 1 through 7 is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

C. Access to Accountants' Working Papers

At its discretion, SBA may assign its examiners or other personnel to review the accountant's working papers. The audit engagement agreement between the Licensee and the IPA shall provide that the accountant's working papers will be made available for review upon request of the SBA.

D. Accountants' Responsibility for Valuations

i. The investment portfolios of virtually all SBICs contain nonmarketable securities, the values of which must be estimated in the absence of readily ascertainable market values. It is the responsibility of the Board of Directors or the General Partner(s) to estimate the value of such securities in good faith.

ii. The IPA does not act as an appraiser for security values estimated by the Board of Directors or General Partner(s), and is not expected to perform an audit of the portfolio concerns. The IPA's review of a Licensee's portfolio valuations shall address the following questions:

- (1) Does the Licensee have a written valuation policy which has been approved by SBA?
- (2) Do the Licensee's valuations of its portfolio concerns reflect consistent adherence to its valuation policy?

(3) Has the Licensee documented the basis for its valuations, and does such documentation indicate that a reasonable analysis of available information has been performed?

iii. Based upon the auditing procedures performed, the IPA shall express an opinion as to whether the Licensee's valuation procedures are reasonable and the documentation is appropriate.

iv. SBA requirements concerning portfolio valuations are set forth in Appendix II to Part 107. Appendix II contains recommended valuation techniques for securities of various types, as well as requirements concerning written valuation policy, frequency of valuation, and documentation. A Licensee has the option of adopting the model valuation policy included in Appendix II or obtaining SBA approval of an alternative valuation policy.

v. In addition to the SBA valuation requirements, IPAs may also wish to review SEC Accounting Series Release No. 118 (section 404.03, “Codification of Financial Reporting Policies”).

vi. The IPA shall test a sufficient number of valuations to support an opinion. Testing of valuations representing less than 50 percent of the value of the entire portfolio shall be presumed to be insufficient to support an opinion.

vii. If the audit discloses that the valuation procedures are inadequate, unreasonable or inconsistent with the Licensee's valuation policy, or that the underlying documentation does not adequately support the valuations, the IPA's opinion shall be modified to indicate a lack of conformity with generally accepted accounting principles. The opinion may be qualified (using the phrase “except for”) or, depending upon the possibility of a material misstatement, the accountant may determine that an adverse opinion is appropriate.

E. Audit Adjustments

All audit adjustments shall be entered in the Licensee's records before issuance of the Independent Auditors' Report. As a result, the financial statements accompanying the report will agree with the books as adjusted as of the statement date, giving consideration to reclassification of account balances for report purposes. If the adjustments are not so recorded on the Licensee's books, a statement shall be made by the IPA to this effect.

F. Reporting Irregularities

i. *Reporting Irregularities and Illegal Acts to SBA.* An independent public accountant that detects irregularities or illegal acts individually or collectively material to the financial statements, or irregularities or illegal acts relative to SBA programs whether or not material, shall advise management in writing. Management, in turn, shall immediately advise, in writing, the Associate Administrator for Investment, Investment Division, 409 Third Street, SW, Washington, DC 20416. Management, in advising SBA, shall, to the extent practicable, describe the irregularities or illegal acts and their effects on the financial statements and SBA programs. Auditors shall determine whether management reported the irregularities or

illegal acts and, if management fails to report, the auditor shall report to SBA at the address listed above.

ii. *Reporting Internal Control Structure Reportable Conditions.* Reportable conditions in an SBIC's internal control structure shall be reported to SBIC management in writing and SBIC management shall immediately transmit this auditor's report to SBA. Reportable conditions and the manner of reporting such conditions are addressed in AU Section 325, *Codification of Statements on Auditing Standards*, issued by the American Institute of Certified Public Accountants.

G. Detecting Noncompliance With Laws and Regulations

i. Audits of SBICs are performed in accordance with generally accepted auditing standards. These standards require IPAs to design audit procedures which will provide reasonable assurance of detecting instances of noncompliance with applicable laws and regulations that could have a material effect on Licensees' financial statements.

ii. A GAAS audit is neither a substitute for nor a duplication of the examination of an SBIC performed by SBA's examiners. The purpose of such examinations is to provide a comprehensive evaluation of the Licensee's compliance with laws and regulations governing the SBIC program. In contrast, IPAs perform audits in which compliance issues are viewed in the context of the possible effects of noncompliance on the financial statements.

iii. As part of the audit planning process, all IPAs shall be responsible for reviewing and becoming familiar with the laws and regulations applicable to SBICs. Auditors must have sufficient knowledge of such laws and regulations to be able to design appropriate audit procedures for an SBIC, and to recognize instances of noncompliance which may become evident in the course of performing such procedures. The laws and regulations governing the SBIC program include the following:

1. *Small Business Investment Act of 1958, as amended (Act).* The Act (15 U.S.C. 681 et seq.) provides a statement of the public purpose of the SBIC program and establishes the legislative framework upon which the regulations are based. Licensees are permitted to engage in activities contemplated by the Act, and in no other activities. Provisions of the Act governing SBICs are found primarily in Title III.

2. *Code of Federal Regulations, title 13, parts 107 and 121 (13 CFR 107 and 121).* Part 107 contains the regulations governing the SBIC program, and auditors should become familiar with this part in its entirety. Part 121 contains small business size regulations which apply to various SBA programs; particular attention should be given to the definition of "Affiliation" (§ 121.401) and the SBIC size standard (§ 121.802).

iv. In addition to the Act and regulations themselves, SBA has various materials available which may assist auditors in developing an overall understanding of the SBIC program. These include basic informational brochures about the program; the preambles to final rules published in the

Federal Register, which provide rationales for and interpretations of new regulations; and a regulatory compliance checklist for small business financings.

v. Preparation for an SBIC audit should include a review of AICPA Statement on Auditing Standards No. 54 (SAS 54). This statement discusses the consideration an auditor should give to the possibility of illegal acts by a client in a financial statement audit performed in accordance with GAAS. As defined in the statement, "illegal acts" include violations of laws or government regulations.

vi. In addition to any specific audit procedures deemed necessary which may relate to compliance issues, the IPA shall obtain representation from the Licensee regarding its lawful operation as contemplated by the Act.

V. Accounting Policies and Procedures

A. Generally Accepted Accounting Principles

i. As a general rule, Licensees shall follow generally accepted accounting principles (GAAP) as promulgated by the Financial Accounting Standards Board, its predecessors (such as the Accounting Principles Board), and the AICPA. Sources of information concerning specialized accounting and reporting principles for investment companies include the AICPA publication, "Audits of Investment Companies", as well as this accounting guide. In the event of any conflict between this appendix and other sources, this appendix shall govern for purposes of financial reporting to SBA.

ii. Licensees and their IPAs should be aware that some of the specialized GAAP promulgated for investment companies is oriented towards companies which do not share many of the characteristics of SBICs. Appendix A of "Audits of Investment Companies" discusses some of the distinctive characteristics of venture capital companies in general, and of SBICs in particular, relative to other types of investment companies. These characteristics may include active rather than passive investment, illiquid portfolios with no public market, relatively long holding periods for investments, and the existence of significant debt in the case of SBICs.

iii. Appendix A includes the following statement: "Though all venture capital investment companies should prepare their financial statements in conformity with generally accepted accounting principles and are subject to audit as are other investment companies, the statement presentation of some companies may need to be tailored to present the information in a manner most meaningful to their particular group of investors." SBA, as the regulator and major creditor of the SBIC industry, has tailored Form 468 to provide financial information in a format which will satisfy SBA's analytical and regulatory requirements. An IPA should exercise professional judgment in determining whether reporting on Form 468 requires a material departure from GAAP for a particular SBIC. If such a departure exists, the Independent Auditors' Report should be modified accordingly.

B. Accrual Basis of Accounting

Books of account shall be maintained on an accrual basis. All accruals are to be entered in the records and posted at the end of the fiscal year, and as of the closing dates of any other fiscal periods to be covered by interim or special financial report to SBA.

C. Reporting Entity

i. For most SBICs, the reporting entity is the Licensee only. Application of this general rule and certain exceptions to it are discussed in this paragraph C.

ii. Investment in Management Services Company. The provisions of § 107.501(c) permit a Licensee to organize a wholly-owned corporation solely to provide management services. The regulation states that reports submitted to SBA shall reflect the consolidated results of the Licensee and its subsidiary.

iii. Investment in Section 301(d) Licensee. Under § 107.712, a Section 301(d) Licensee may be licensed to operate as the subsidiary of one or more Licensee companies ("Participant Licensees"), with or without non-Licensee participation. Each Participant Licensee shall own at least twenty percent of the voting securities of the Section 301(d) Licensee. Such an investment should be reported on the equity method, under the caption "Investment in 301(d) Licensee" on the Statement of Financial Position. SBA recognizes that this accounting treatment may constitute a departure from GAAP if the Participant Licensee is the majority owner of the Section 301(d) Licensee. The independent public accountant may wish to express a qualified opinion if the departure is considered material.

iv. Temporary Control. Under certain circumstances, as described in § 107.801, a Licensee may temporarily own more than a 50 percent interest in a small business concern. These investments shall be classified in the appropriate category of Loans and Investments on the Statement of Financial Position (generally, this will be "Operating Concerns Acquired"), and shall be reported at their fair value. This treatment is consistent with FASB Statement No. 94, which provides an exception to the general rule of consolidating majority-owned subsidiaries when control is likely to be temporary.

D. Fair Value of Loans and Investments

i. In accordance with generally accepted accounting principles for investment companies, SBICs shall report Loans and Investments (presented on lines 1 through 10 of the Statement of Financial Position, page 2 of SBA Form 468) at fair value. To the extent possible, fair value shall be represented by quoted market prices (appropriately discounted for such factors as restrictions on marketability or large holdings relative to daily trading volume). In the absence of quoted market prices, fair value shall be an estimate determined in good faith by the Board of Directors or General Partner(s), based on the application of valuation policies which are consistent with SBA guidelines.

ii. In response to new statutory requirements concerning valuations, SBA

published regulations which included new § 107.101(g) as well as a new Appendix II to Part 107, "Valuation Guidelines for SBICs". These new valuation regulations supersede the guidelines previously published in SBA Policy and Procedural Release #2006. Licensees may adopt the model valuation policy included in Appendix II or submit an alternate policy to SBA for approval. In addition to valuation policy, § 107.101(g) and Appendix II also set forth requirements concerning frequency of valuation, documentation, and responsibility for valuations.

iii. The following statement is included in § 107.101(g): "The boards of directors of corporations and the general partners of partnerships shall have sole responsibility for adopting the Licensee's valuation policy and, pursuant thereto, for valuing Loans and Investments of such Licensee." This statement establishes responsibility for all valuations assigned to portfolio securities by the Licensee. SBA, in its capacity as a regulator, retains the same oversight responsibilities over valuations as it does over all other issues affecting regulatory compliance.

iv. Accounting considerations. Licensees shall maintain separate general ledger accounts for the original cost of Loans and Investments and any valuation adjustments thereto. Valuation adjustments shall be in the form of unrealized appreciation or depreciation, respectively representing valuations above or below cost. The sum of cost and unrealized appreciation or depreciation represents fair value.

v. Unrealized appreciation may be recognized on equity investments and debt investments which contain equity features, such as options or warrants. Recognition of unrealized appreciation on loans is not permitted under SBA's valuation guidelines.

vi. A general allowance for losses on Loans and Investments is not utilized in fair value accounting. Rather, the Licensee's Board of Directors or General Partner(s) shall value Loans and Investments individually as of the financial statement date. This requirement applies equally to Licensees engaged in equity investing and in lending. A Licensee which is primarily engaged in lending, however, may also identify additional anticipated losses on the basis of its portfolio history, industry experience, or other relevant factors; such amounts may be reported in the Statement of Financial Position of SBA Form 468 as additional unrealized depreciation not associated with specific portfolio assets.

vii. An appropriate tax provision shall be established for net unrealized appreciation on securities held by taxable corporate Licensees. There may also be circumstances in which a tax benefit for net unrealized depreciation should be recognized, depending on the likelihood of realization. Such a provision or benefit shall be determined in accordance with FASB Statement No. 109, "Accounting for Income Taxes".

E. Interest Income

i. Interest income shall be accrued according to the terms of interest bearing

loans and investments. Premiums or discounts associated with debt instruments represent adjustments to interest income which shall be amortized over the stated life of the debt instrument.

ii. *Collection in Doubt.* Interest income shall not be recognized if collection is doubtful. Licensees may choose to handle doubtful interest receivable in either of two ways: (1) Make no entry to accrue interest in the regular general ledger accounts and track interest due in a memorandum account; or (2) accrue the interest and provide a 100% reserve (debit provision for loss on receivables, credit allowance for uncollectible interest receivable). The method used by the Licensee must be disclosed in the footnote to the financial statements summarizing significant accounting policies.

iii. Collection of interest is presumed to be in doubt when either or both of the following conditions occur: (1) The small concern is in bankruptcy, insolvent, or there is substantial doubt about its ability to continue as a going concern; or (2) the small concern is in default more than 120 days to the Licensee. Licensees may rebut this presumption by providing evidence of collectibility satisfactory to SBA. Such evidence may include the existence of collateral, the value of which has been verified through an appraisal by an independent professional appraiser acceptable to SBA. Such an appraisal shall be at liquidation value (net of liquidation costs) and shall have been performed within the 12 months immediately preceding the valuation date. In considering whether collateral provides an appropriate basis for valuations, SBA will consider the nature of a Licensee's claim on the collateral (for example, whether other parties have security interests senior to the Licensee's, or whether the Licensee's security interest in an asset is perfected). SBA will also review the Licensee's operating history for evidence concerning its willingness and ability to pursue available remedies (including foreclosure) in default situations.

iv. The two conditions cited in the preceding paragraph are not the only possible indicators of a collection problem. Even if neither condition is present, other circumstances may cause the Board of Directors or General Partner(s) to conclude that collection is in doubt.

v. When interest income is not being recorded on a loan or debt security, the Licensee shall so note in its Annual Financial Report on Form 468. The note should include the date at which interest accrual was discontinued. In addition, the total amount of interest not accrued because collection is in doubt shall be disclosed in a footnote to the financial statements.

vi. When the accrual of interest is discontinued, the full amount of any interest receivable recorded in prior periods must be either reversed or fully reserved.

F. Dividend Income

i. Dividend income from investments in common or preferred stock is normally recognized as of the date of record (the date at which official ownership of shares is determined for the purpose of paying the

dividend). Dividend income shall not be accrued in the absence of a dividend declaration by the small concern's board of directors. This treatment shall apply to all dividends, including dividends on redeemable preferred stock or similar securities with some debt-like characteristics.

ii. Any cash distribution which is identified as a return of capital shall not be recognized as income. Such distributions are a reduction in the cost basis of an investment.

iii. Stock splits and stock dividends (in stock of the same class as that owned) are not income because the Licensee's proportional interest in the small business concern does not change as a result of such events. The cost of the shares previously held should be allocated, on a rational basis, to the number of shares held after the split or dividend. Similarly, when stock rights are received, a portion of the cost basis of the related investment may be allocated to the rights.

iv. Dividends in kind are recorded as income at the fair value of the property received. Such income should be classified as Non-Cash Gains/Income in the Statement of Financial Position of SBA Form 468. If the Licensee has a choice between a dividend in cash or in kind, and chooses to receive an in-kind dividend, the fair value is deemed to be the amount of cash that could have been received.

G. Profit Participation in Small Concerns

Participation in the profits of a loan- or debt-financed small business concern represents additional interest income to the Licensee. For regulatory purposes, any profits received must be included in the calculation of the Cost of Money.

H. Fees Charged to Small Concerns

i. Income from nonrefundable fees charged by SBICs in connection with the origination of loans shall be deferred and amortized over the term of the financing, regardless of whether or not such fees are included in the Cost of Money. Licensees should be aware of the provisions set forth in § 107.402 (d) through (g) concerning permissible fees, prepayment penalties, obligations of SBICs to provide certain fee-related information in writing to small concerns, and circumstances in which SBICs may be required to refund fees paid by small concerns.

ii. If a Licensee has made a commitment for a financing which does not take place, any processing fees which the Licensee is permitted to retain pursuant to § 107.402(d) shall be recognized as income upon expiration of the commitment.

I. Accounting for Investments in Flow-Through Entities

i. On SBA Form 468, in the Statement of Operations Realized, Licensees are asked to report income (loss) from investments in partnerships or other types of flow-through entities. This category of investments is intended to include any entity which allocates its income and losses to its equity holders and is not taxed at the entity level. Any such investments made by SBICs would most commonly be in limited partnerships.

ii. For investments of this type, original cost is adjusted at the end of each accounting

period to recognize the investor's share of earnings or losses of the investee. The amount of the adjustment is included in the net income of the investor. Distributions received from an investee reduce the carrying amount of the investment.

iii. It should be noted that the steps in the preceding paragraph determine only the cost basis of investments. Any investment included in an SBIC's portfolio of Loans and Investments still must be valued by the Board of Directors or General Partner(s) and presented at fair value in the Licensee's financial statements.

iv. Any income from investment in flow-through entities must be included initially in Non-cash Gains/Income, as discussed in paragraph X of this section V. When a Licensee actually receives a distribution from the investee, the amount received should be reclassified from Non-cash Gains/Income to Undistributed Net Realized Earnings.

J. Equity Method of Accounting

i. The only type of investment which shall be accounted for under the equity method is an investment in the common stock of a Section 301(d) Licensee, as permitted under § 107.712. Since a Licensee investing in a Section 301(d) Licensee is required to have an ownership interest of at least 20 percent, use of the equity method will normally be appropriate. Under the equity method, original cost is adjusted at the end of each accounting period to recognize the investor's share of earnings or losses of the investee. The amount of the adjustment is included in the net income of the investor. Dividends or distributions received from an investee reduce the carrying amount of the investment.

ii. Licensee should not use the equity method to account for investments in the common stock of small business concerns, even if a Licensee's ownership interest exceeds 20 percent. SBICs, whether or not registered under the Investment Company Act of 1940, are exempt from the usual requirements concerning use of the equity method because they account for investments at fair value (see APB Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock", paragraph 2).

K. Accounting for Income Taxes

i. In February 1992, the FASB issued Statement No. 109, "Accounting for Income Taxes". The Statement is effective for fiscal years beginning after December 15, 1992. Statement No. 109 supersedes FASB Statement No. 96, as well as APB Opinion No. 11, which many companies continued to follow during the period when adoption of Statement No. 96 was optional.

ii. Statement No. 109 establishes the following basic principles to be applied in accounting for income taxes at the date of financial statements:

(1) A current tax liability or asset is recognized for the estimated taxes payable or refundable on tax returns for the current period.

(2) A deferred tax liability is recognized for the estimated future tax effects of "taxable temporary differences" (events which will result in future taxes payable).

(3) A deferred tax asset is recognized for the estimated future tax effects of "deductible temporary differences" (events which will result in future tax savings), operating loss carryforwards, and tax credit carryforwards.

(4) A valuation allowance is recognized to reduce the deferred tax asset to the extent that the tax benefits are not expected to be realized.

(5) Both current and deferred tax liabilities and assets are based on provisions of the enacted tax law; the effects of future changes in tax laws or rates are not anticipated.

iii. The ability to recognize deferred tax assets under certain circumstances represents a significant change from earlier pronouncements. Licensees which recognize deferred tax assets should take careful note of the requirements of Statement No. 109 in determining whether it is "more likely than not" that such assets will be realized. Generally, application of the "more likely than not" standard means that when "negative evidence" exists which suggests that benefits will not be realized, there must be sufficient "positive evidence" to outweigh it; otherwise, a valuation allowance is required.

iv. Because SBICs must report their Loans and Investments at value, many Licensees will find it necessary to apply the criteria of Statement No. 109 in determining whether to recognize deferred tax liabilities or assets reflecting the estimated future tax effects of unrealized gains or losses. Both unrealized gains and unrealized losses are temporary differences as defined in the statement. Previously, SBA required Licensees with net unrealized appreciation to record a provision for estimated future taxes, but did not permit Licensees with net unrealized depreciation to record a corresponding benefit. In accordance with current GAAP, such a benefit may now be recorded.

v. The reporting of unrealized gains and losses and the related tax effects must be consistent. Since SBIC program accounting guidelines require that changes in unrealized appreciation or depreciation be excluded from net income (that is, they do not appear in the statement of operations realized), it follows that the related tax effects must be similarly excluded. Both elements, however, are included in "comprehensive income" (that is, they affect the equity of Licensees). This is reflected in the presentation of net unrealized appreciation or depreciation, net of estimated future tax effects, as Unrealized Gain (Loss) on Securities Held in the Capital section of the Statement of Financial Position.

L. Realized Gain (Loss) on Investments

i. Realized gain or loss on investment shall be recorded by Licensees in accordance with generally accepted accounting principles.

ii. Capital gains realized on the sale of securities shall be recognized provided that collection of proceeds is reasonably assured and the earnings process is complete. For the earnings process to be considered complete, the Licensee must have no further obligation related to the transaction. Any transaction with recourse upon the Licensee or involving any understanding, agreement, option, privilege, or other rights to repurchase by

and/or resell to the Licensee shall not be considered as a final transaction. Transactions which do not meet the criteria in this paragraph L for current recognition of gains shall be accounted for using an appropriate alternate method, such as the installment method or the cost recovery method. Under the installment method, a portion of the gain is recognized with each installment payment received; under the cost recovery method, no gain is recognized until the full amount of the seller's cost has been collected.

iii. Capital losses may arise not only from sales, but also from write-offs or charge-offs of securities held (the two terms are generally used synonymously in this appendix; in contrast, the term "write-down" refers to the recording of unrealized depreciation). Write-offs may be either full or partial. Writing off an investment, in comparison with recording unrealized depreciation, represents a stronger judgment concerning loss of value. However, it is not necessary to have a definitive event (such as bankruptcy of the small business concern) in order to write off an investment. Generally accepted accounting principles call for the recognition of loss when it becomes evident that previously recognized future economic benefits of an asset have been reduced or eliminated.

iv. A Licensee may also realize capital gains or losses in connection with the exchange or non-reciprocal transfer of securities. The treatment of such transactions is governed by APB Opinion No. 29, "Accounting for Nonmonetary Transactions", and is discussed in paragraph M of this section V.

v. If a Licensee acquires shares of an investee's stock (of the same class) at different times and prices, SBA requires that the average cost method be used to determine the cost of such securities when sold.

vi. When a gain or loss is realized, whether as a result of the sale, other disposal or write-off of an asset, any previously recorded unrealized appreciation or depreciation associated with the asset shall be reversed.

vii. Non-cash Gains. When a Licensee realizes capital gains, but does not receive cash at the time of the transaction, SBA requires Licensees to segregate such "Non-cash Gains" from other components of Undistributed Realized Earnings, until such time as any non-cash assets received are converted to cash. Non-cash Gains are realized earnings which have been recognized in the Licensee's Statement of Operations. They are segregated in the Statement of Financial Position only because they are subject to certain restrictions under SBA regulations, primarily concerning distributions. In effect, Non-cash Gains can be considered a type of restricted retained earnings. For further information on Non-cash Gains, see "Undistributed Realized Earnings" in paragraph X of this section V.

M. Nonmonetary Transactions

i. Licensees should follow APB Opinion No. 29 to the extent applicable when accounting for nonmonetary transactions. Such transactions include both reciprocal and non-reciprocal transfers of nonmonetary assets or liabilities between the Licensee and

another entity or person, or between the Licensee and its stockholders or partners. The cost of an asset acquired in a nonmonetary transaction is the fair value of the asset relinquished to obtain it, and a gain or loss should be recognized on the exchange. Any gain recognized shall be reported on SBA Form 468 as a Non-cash Gain.

ii. Nonmonetary transactions in which the Licensee exchanges certain securities or assets for other securities or assets will result in the realization of gain or loss for financial reporting purposes, regardless of whether such transactions are taxable or non-taxable exchanges.

iii. Fair value of a nonmonetary asset transferred to or from a Licensee should be determined by referring to estimated realizable values in cash transactions of the same or similar quoted market prices, independent appraisals, estimated fair values of assets, or other available evidence.

iv. In cases where the values are not clearly determinable, assets received will have the same accounting basis as the assets transferred.

v. Dividends In Kind and Spin-offs. Dividends or other distributions in kind, consisting of shares of a small business concern or other securities, are nonreciprocal transfers of non-monetary assets from a Licensee to its owners. Such transfers shall be reported at the fair value of the assets distributed.

N. Interest, Notes and Accounts Receivable

i. Interest Receivable. In reporting interest receivable, Licensees should make certain that amounts are properly classified between current and noncurrent assets. Current assets are those providing benefits which are expected to be realized within the next fiscal year.

ii. Interest receivable is reported net of an allowance for uncollectible amounts, which represents a conservative estimate of probable losses. The allowance shall be adjusted, at a minimum, as of the end of the fiscal year. Interim adjustment to reflect changes in the status of receivables is strongly encouraged. See paragraph E ("Interest Income") of this section V for guidelines to be used by SBICs in evaluating the collectibility of interest income.

iii. Expense is recognized whenever the allowance for uncollectible amounts is adjusted to reflect a change in the valuation of interest receivable. An actual write-off of interest receivable is normally recorded as a reduction of the receivable and a corresponding reduction of the allowance, and does not result in the recognition of expense.

iv. The total expense recognized during a fiscal year with respect to uncollectible interest receivable appears on Form 468 in the Statement of Operations Realized, under the caption, "Provision for Losses on Accounts Receivable."

v. Requirements concerning the recording of interest receivable and the related interest income appear in this appendix under the heading, "Interest Income."

vi. Notes and Accounts Receivable. The accounting treatment of notes receivable and

accounts receivable shall be governed by the same rules which apply to interest receivable, as previously described in this paragraph N.

vii. Notes Receivable represents the unpaid balance of miscellaneous notes which do not fit into any category of Loans and Investments. It does not include notes representing amounts due from purchasers of assets acquired in liquidation of portfolio securities, which are presented separately in the Loans and Investments section of the Statement of Financial Position on Form 468.

viii. Accounts Receivable represents amounts due on account, such as for management consulting, appraisal, or other services rendered. Accounts Receivable also includes accrued fees for services rendered in connection with participations or joint financings and accrued fees receivable from small concerns.

O. Compensating Balances

i. In those instances where idle funds are encumbered or are required to be maintained at a financial institution as compensating balances in connection with debt of the SBIC, the nature of the encumbrance and the terms of any applicable agreements shall be disclosed in a footnote to the financial statements.

ii. Depending upon the specific terms, it may be necessary to classify idle funds subject to a compensating balance agreement as non-current assets.

P. Organization Costs

i. Organization costs are incurred in the formation of an SBIC and may include such items as legal fees, incorporation and various other fees imposed by states, and promotional expenditures. SBICs should amortize organization costs over a term of not more than five years.

ii. If an SBIC incurs organization costs which are deemed by SBA to be unreasonable or excessive, such costs must be excluded from Regulatory Capital as long as they are carried as an asset by the SBIC. Once such costs have been amortized to expense, the regulatory deduction is no longer required. No deduction is ever required for organization costs accepted by SBA as reasonable.

iii. Operating losses incurred by a company prior to licensing as an SBIC are not considered organization costs and shall not be capitalized.

Q. Contingent Liabilities

i. Licensees shall accrue or disclose contingent liabilities, as appropriate, in accordance with the requirements of FASB Statement No. 5. Such requirements vary depending upon whether the likelihood of realizing a loss is evaluated as "probable", "reasonably possible", or "remote". Contingent liabilities may arise from such transactions or events as the issuance of guarantees, pending litigation, and the sale of portfolio interests with recourse.

ii. In addition to the reporting requirements of FASB Statement No. 5, Licensees and their IPAs should be familiar with SBA's requirements for reporting of certain contingencies. These additional requirements include the completion of the

Schedule of Guarantees (include in SBA Form 468) by Licensees which have guaranteed the obligations of small concerns and the filing of a litigation report by Licensees which become a party to litigation (see § 107.1002(f)).

iii. A Licensee which has sold portfolio securities (or any interest therein) on a recourse basis should be aware that any amounts for which it may be contingently liable must be treated as investments in small concerns for overline purposes (see §§ 107.707(b) and 107.303).

R. Transactions with Related Parties

i. Licensees shall disclose material transactions with related parties in accordance with FASB Statement No. 57. In applying the requirements of this pronouncement to SBIC financial statements, a Licensee shall consider the term "related party" to encompass any person or entity which is an Associate as defined in § 107.3. Footnote disclosures of related party transactions shall include the name of the related party as well as the nature of the relationship.

ii. Licensees and their IPAs should be aware that certain transactions involving Associates are either prohibited by SBA regulations or permitted only with SBA's prior written approval. See § 107.903 ("Conflicts of Interest").

S. Leverage—Debentures Guaranteed or Purchased by SBA

i. SBICs which qualify on the basis of financial soundness and regulatory compliance are eligible to receive long-term leverage in the form of five-year or ten-year debentures guaranteed (or, in some cases, purchased directly) by SBA. Debentures with an interest rate subsidy of three percentage points for the first five years of their term are available to Section 301(d) Licensees only.

ii. Debentures, net of current maturities, shall be classified in the financial statements as long-term debt, and shall be shown at face value in the Statement of Financial Position of Form 468.

iii. Licensees issuing debentures pay a user fee (currently 2 percent of the amount borrowed) and an underwriter's fee (currently .625 percent). These fees shall be capitalized and amortized over the life of the debenture. Generally accepted accounting principles normally require that debt be reported net of the unamortized portion of related fees; Licensees, however, should report the unamortized fees as an asset and the debentures at their gross amount. SBA does not believe that this treatment will constitute a material departure from GAAP for most Licensees.

iv. Debentures are subject to the terms and conditions set forth in SBA regulations. In most respects, debentures incorporate by reference the regulations as amended from time to time. With respect to events of default, however, debentures incorporate those events and associated remedies in existence at the date of issue. Thus, debentures issued at different times may be subject to different default provisions. Events of default include both financial and regulatory conditions, which may result in

the entire indebtedness of the Licensee being declared due and payable.

v. If SBA decides to demand payment in accordance with the acceleration provisions of the debentures, such demand ordinarily will be presented in a letter specifying the violations that have occurred.

T. Leverage—Participating Securities Guaranteed by SBA

i. Participating Securities are redeemable preferred equity-type securities. Issuers are required to make equity investments in an amount at least equal to the amount of Participating Securities issued (see the defined term "Equity Capital Investments" in § 107.3 for the specific categories of investments permitted). The structure, terms and conditions of the Participating Security are set forth in detail in §§ 107.240 through 107.247.

ii. The Act authorizes SBA to guarantee Participating Securities issued in the form of limited partnership interests, preferred stock, or debentures with interest payable only to the extent of earnings. Currently, the only form of Participating Security for which documentation has been created is a limited partnership interest to be held by SBA. Other forms will be made available in the future as required to meet the needs of Licensees.

iii. The Participating Security has the following significant features:

(1) Licensees issue Participating Securities to SBA, which in turn assigns certain of its interests in such securities to a pool. Investors (known as "certificate holders") then purchase interests in the pool through a public offering. Each Licensee issuing Participating Securities pays a cumulative preferred return ("Prioritized Payments") which is passed through to the certificate holders, but such payments are contingent upon the profitability of the issuer. Any Prioritized Payments which exceed the cumulative earnings of a Licensee will be paid to the certificate holders by SBA as guarantor. The Licensee, however, will be ineligible to make any other profit distributions until it has paid all of its Prioritized Payments (including reimbursement of amounts previously advanced on its behalf by SBA).

(2) In consideration for SBA's guarantee, profitable Licensees must pay a percentage of earnings to SBA as "Profit Participation". SBA's profit percentage (the "Profit Participation Rate") depends upon the Licensee's ratio of Participating Securities issued to Leverageable Capital, as well as the interest rate on 10-year Treasury securities at the time each Participating Security was issued.

(3) Except for Prioritized Payments, SBA (the "Preferred Limited Partner") and the Licensee's private limited partners receive distributions at the same time, allocated in accordance with legislative formulas.

(4) The securities have a 10-year term, at the end of which redemption is mandatory. It is expected, however, that most Participating Securities will be redeemed, at least in part, before the mandatory redemption date.

iv. Participating Securities will be reported in a "Redeemable Securities" section of the

Statement of Financial Position on SBA Form 468. The amount of Participating Securities issued represents the capital contribution of SBA, the Preferred Limited Partner. SBA's capital account will increase by the amount of any Prioritized Payments or Profit Participation which the Licensee becomes obligated to pay on the basis of profits earned, and will decrease as distributions are actually received. Distributions to SBA will be applied as Prioritized Payments, Profit Participation, or redemptions of outstanding leverage in accordance with §§ 107.243 through 107.245.

v. In a footnote to the financial statements, the Licensee shall provide a description of the terms of the Participating Securities issued, including disclosure of the mandatory redemption date. If there are any "accumulated" Prioritized Payments (representing a contingency for amounts paid to certificate holders by SBA on the Licensee's behalf, which the Licensee must repay as profits are realized), a footnote shall provide the dollar amount of the accumulation for the current fiscal year period and the aggregate amount accumulated.

vi. For companies licensed after March 31, 1993, the obligation to pay Prioritized Payments and Profit Participation is conditioned upon the profitability of the Licensee as a whole. Those licensed earlier, however, may be permitted to exclude profits attributable to portfolio assets in existence as of March 31, 1993.

vii. Because of the complexity of the required profit and distribution computations, all Licensees issuing Participating Securities shall use SBA-provided software to perform such computations.

U. Preferred Securities Leverage for Section 301(d) Licensees

i. *Four Percent Preferred Securities.* Section 301(d) Licensees which qualify on the basis of financial soundness and regulatory compliance are eligible to receive long-term leverage by selling 4% redeemable preferred securities (either preferred stock or a preferred limited partnership interest) directly to SBA. Such securities must be redeemed not later than 15 years from the date of issuance, at which time any unpaid portion of the preferred and cumulative 4% return due to SBA must also be paid. No distributions may be made to any investor other than SBA unless the Licensee is current on all amounts due SBA.

ii. Like Participating Securities, 4% preferred securities will be reported in the "Redeemable Securities" section of the Statement of Financial Position on SBA Form 468. Unlike Participating Securities, however, which specifically provide for the extinguishment of any obligation to pay Prioritized Payments in excess of the issuer's profits, the legislation which authorized 4% preferred securities does not set forth any circumstances in which the 4% return would be extinguished.

iii. The initial carrying amount of 4% preferred securities shall be the purchase price paid by SBA at the date of issue (for 4% preferred stock issued by corporate

Licensees, this amount must be equal to the par value). At the end of each accounting period, the carrying amount shall be increased by the amount of any 4% returns not currently paid or declared. A breakdown of the total carrying amount, showing separately the purchase price of 4% preferred securities and the accrued 4% returns in arrears, is reported on the Statement of Financial Position.

iv. Cumulative 4% returns in arrears must be recorded as a charge against Undistributed Net Realized Earnings. For some Section 301(d) Licensees, these amounts may exceed Undistributed Net Realized Earnings.

Ordinarily, a company in these circumstances would reduce paid-in capital or partners' contributed capital by the amount of the excess. Because such treatment would reduce Regulatory Capital, however, it could result in certain unintended regulatory compliance problems for Licensees (such as overline violations). Therefore, on SBA Form 468, Licensees shall report all 4% returns in arrears as a reduction of Undistributed Net Realized Earnings, even though this treatment may result in a deficit, and shall not reduce paid-in capital or partners' contributed capital.

v. Because Section 301(d) Licensees must charge the 4% return to Undistributed Net Realized Earnings whether it is paid or not, any unpaid amounts must be added back in order to determine a Licensee's Retained Earnings Available for Distribution. Unpaid 4% returns must be paid in full from Retained Earnings Available for Distribution before any other distributions can be made.

vi. In a footnote to the financial statements, the Licensee must provide a description of the terms of the preferred securities issue, including disclosure of the mandatory redemption date. If there are 4% returns in arrears, a footnote shall provide the dollar amount of the arrearage for the current fiscal period, the aggregate amount in arrears, and the number of periods in arrears.

vii. *Three Percent Preferred Stock.* Before November 21, 1989, corporate Section 301(d) Licensees were eligible to receive long-term leverage by issuing 3% cumulative preferred stock to SBA at par value. Three percent preferred stock has no mandatory redemption date and is classified as equity for financial reporting purposes. However, it shall not be treated as Regulatory or Leverageable Capital for any purpose.

viii. No dividends may be paid to any investor other than SBA unless the Licensee is current on all 3% preferred dividends due SBA.

ix. *Three Percent Preferred Stock Repurchase Program.* SBA published in the **Federal Register** a notice announcing the implementation of a program under which Section 301(d) Licensees may apply to repurchase their outstanding 3% preferred stock from SBA at a set price of 35 percent of par value. Specific guidelines governing repurchase transactions are set forth in SBA Policy and Procedural Release #2021, issued June 14, 1994. Licensees will have three years from the date of the Policy and Procedural Release during which to apply for and complete the Repurchase Program.

x. Participants in the Repurchase Program will receive detailed accounting guidance

from SBA at the time their repurchases are completed. In general, when a company repurchases its own stock at a discount (that is, for less than the original issue price), it records an increase in paid-in surplus equal to the discount. Section 301(d) Licensees will follow this general rule, but the increase in surplus attributable to the repurchase must be separately identified (as "Restricted Contributed Capital Surplus") on SBA Form 468 because it is subject to certain restrictions for regulatory purposes.

V. Contributed Capital and Committed Capital

i. In general, "contributed capital" refers to funds contributed to a Licensee by private investors (although such funds may also include "qualified nonprivate funds" from State and local government sources, in accordance with the definition of Private Capital in § 107.3). Although some Licensees may obtain financial assistance through the issuance of equity-type securities purchased or guaranteed by SBA, such securities are reported on Form 468 as SBA leverage rather than as contributed capital. The contributed capital of a corporate Licensee consists of the par value of its capital stock (which may consist of one or more classes or stock) and its aggregate paid-in surplus, excluding Restricted Contributed Capital Surplus obtained through the repurchase of 3 percent preferred stock from SBA. For a partnership Licensee, contributed capital consists of proceeds from the sale of partnership interests to the general partners and the limited partners (other than SBA). For all Licensees, contributed capital shall be recorded net of expenses incurred to obtain the capital.

ii. Capital contributed to a Licensee in the form of non-cash assets requires the prior approval of SBA, unless such assets are physical assets to be currently employed by the Licensee in its operations (see § 107.705). Equity securities issued in exchange for approved non-cash assets will be excluded from a Licensee's Regulatory Capital until the assets received are converted to cash.

iii. *Commitments from Investors.* In addition to its contributed capital, a Licensee may have outstanding commitments from individuals or entities to invest additional funds in the Licensee at a future date. Binding commitments from Institutional Investors (as defined in § 107.3) may be included in the Licensee's Regulatory Capital; the principal effects of such inclusion are to increase the Licensee's overline limitation (See § 107.303) and to increase the capital base used in the computation of Capital Impairment (see § 107.210(h)).

iv. Unfunded commitments from investors shall not be reported as part of the contributed capital of the Licensee on SBA Form 468. The amount of such commitments shall be disclosed in a footnote to the financial statements, which shall separately identify commitments included in Regulatory Capital and any other commitments outstanding. Any significant terms and conditions associated with investor commitments, including the timing of anticipated drawdowns if known, shall also be disclosed.

W. Unrealized Gain (Loss) on Securities Held

i. Unrealized Gain (Loss) on Securities Held results from the valuation of Loans and Investments by the Board of Directors or General Partner(s). Unrealized appreciation is recognized for valuations above cost and unrealized depreciation is recognized for valuations below cost. Unrealized gain or loss is the aggregate amount obtained by summing the unrealized appreciation or depreciation of all Loans and Investments, net of any estimated future income tax effects.

ii. Unlike some other types of investment companies, such as mutual funds, SBICs do not report changes in net unrealized appreciation or depreciation in the Statement of Operations. Instead, such changes are recorded directly in the capital account, Unrealized Gain (Loss) on Securities Held. SBA requires this treatment for two reasons: (1) because most securities held by SBICs have no readily ascertainable market values and valuation of such securities is highly subjective, SBA prefers that reported net income not be influenced by changes in valuation; and (2) segregation of unrealized gains and losses on the Statement of Financial Position makes it easier to perform certain computations required by SBA regulations.

X. Undistributed Realized Earnings

i. Undistributed Realized Earnings is the defined term used in SBA regulations to represent the earned capital of a Licensee. In general, Undistributed Realized Earnings are the cumulative balance of periodic net investment income (loss) and realized gain (loss) on investments, less dividends or distributions (at times, an SBIC may need to make an adjustment which is not reflected in this general formula). To accommodate regulatory requirements, two components of Undistributed Realized Earnings are presented separately in the financial statements:

ii. Non-cash Gains/Income consists of (1) gains on the disposition of securities realized in the form of notes, securities or any other non-cash assets; (2) income from investments in pass-through entities (such as limited partnerships) which has not been distributed to the Licensee; (3) dividends received in kind; (4) interest income accrued on deferred interest notes, zero coupon bonds or similar instruments; and (5) delinquent accrued interest converted into a new note or added to the principal of an existing note (the amount of such interest which is included in Undistributed Net Realized Earnings must be reclassified to Non-cash Gains/Income).

iii. Non-cash Gains/Income represents realized earnings of an SBIC which have been recognized in the Statement of Operations. Such earnings are segregated in the Statement of Financial Position only because they are subject to certain restrictions under SBA regulations, primarily concerning distributions. In effect, Non-cash Gains/Income can be considered a type of restricted retained earnings.

iv. Classification of capital gains or other income as non-cash items is intended to be temporary. As a Licensee receives payments on a note, receives distributions from a

partnership in which it has invested, sells shares of stock received as a dividend or otherwise converts non-cash assets to cash, amounts initially reported as Non-cash Gains/Income shall be transferred to Undistributed Net Realized Earnings.

v. *Undistributed Net Realized Earnings* is a residual, computed by subtracting the balance in Non-cash Gains/Income from Undistributed Realized Earnings. If an SBIC holds treasury stock, Undistributed Net Realized Earnings are restricted (i.e., not available for distribution) to the extent of the cost of such treasury stock.

Y. Retained Earnings Available for Distribution

i. Retained Earnings Available for Distribution represents, in most cases, the maximum amount that an SBIC may distribute to investors. For SBICs which have received financial assistance from SBA in a form other than debentures, the term "investors" encompasses SBA as well as private investors.

ii. In some instances, SBA is entitled to receive payments from Retained Earnings Available for Distribution on a priority basis, and must receive these payments before any amounts may be distributed to investors or transferred to private capital. Dividends (or equivalent distributions) on 4% preferred securities issued by Section 301(d) Licensees are examples of such payments. In other cases, SBA may be entitled to receive payments from Retained Earnings Available for Distribution in proportion to any distributions received by private investors. Profit participations on Participating Securities are an example of this type of payment.

iii. For most Licensees, Retained Earnings Available for Distribution is computed by subtracting unrealized depreciation on Loans and Investments from Undistributed Net Realized Earnings (excluding any restricted amounts). Unrealized depreciation and unrealized appreciation are not netted in this computation.

iv. For Section 301(d) Licensees which have issued 4% preferred securities, there is one additional element in the computation. Because 4% distributions in arrears are accrued and charged against Undistributed Net Realized Earnings, they must be added back to determine Retained Earnings Available for Distribution.

v. Although partnerships do not ordinarily report retained earnings as such, partnership SBICs must compute Retained Earnings Available for Distribution in the same manner as corporate SBICs. Further discussion of the equity classifications used by partnership SBICs in financial reporting to SBA appears in paragraph Z ("Partnership Capital Accounts") of this section V.

vi. If a Licensee has negative Retained Earnings Available for Distribution as of the end of a fiscal period, and has made or declared a distribution during such period, the distribution may have violated SBA regulations. It is the Licensee's responsibility to show, to the satisfaction of SBA, that it had sufficient Retained Earnings Available for Distribution at the time the distribution was made. In particular, a Licensee should

consider the adequacy of its unrealized depreciation before making a distribution.

vii. Capitalization of Retained Earnings Available for Distribution. Ordinarily, contributed capital and earned capital are maintained and reported separately. In the SBIC program, however, a Licensee which has attained positive Retained Earnings Available for Distribution has the option of "capitalizing" such earnings by permanently reclassifying them as contributed capital. As a result of the reclassification, Undistributed Net Realized Earnings are reduced, while paid-in capital is increased; the net effect is the same as if the Licensee had made a distribution to its owners, who then reinvested the same amount in the Licensee. From a regulatory perspective, this action results in an increase in the Licensee's Leverageable Capital, thus increasing its eligibility for SBA leverage. Capitalization of Retained Earnings Available for Distribution reflects the intent of a Licensee to pursue long-term growth by reinvesting its earnings in small businesses.

viii. 1940 Act Companies. A Licensee which has registered under the Investment Company Act of 1940 may elect to be taxed as a regulated investment company under the Internal Revenue Code (§§ 851 through 855). In general, such a company can avoid taxation at the corporate level if it distributes at least 90 percent of its investment company taxable income for a given year.

ix. Licensees which are (or contemplate becoming) 1940 Act companies should be aware that the distribution requirements imposed on such companies by the Internal Revenue Code may, under certain circumstances, conflict with SBA regulations concerning distributions to shareholders. SBA regulations allow profit distributions to be made only from Retained Earnings Available for Distribution. Any distribution which would exceed Retained Earnings

Available for Distribution requires the prior written approval of SBA.

Z. Partnership Capital Accounts

i. To provide the information necessary to determine compliance with various SBA regulations, Licensees which organize as limited partnerships must divide partners' capital into specified categories. The categories are (1) Partners' Contributed Capital, (2) Unrealized Gain (Loss) on Securities Held, (3) Non-Cash Gains/Income, and (4) Undistributed Net Realized Earnings (Partners' Earned Capital). The sum of these four accounts is the equivalent of the total partners' capital of a non-SBIC partnership. The Licensee must also record the general and limited partners' shares of each capital account, which results in eight separate control accounts for partners' capital.

ii. *Partners' Permanent Capital Contribution.* This balance represents proceeds from the sale of partnership units and any other partners' contributions of cash or other consideration to the partnership, less any returns of capital or other deductions.

iii. *Undistributed Net Realized Earnings and Non-Cash Gains/Income.* The sum of these two accounts represents the total undistributed earned capital of the Licensee. Separate totals must be maintained because SBA rules and regulations do not permit Non-cash Gains/Income to be distributed until they have been converted to cash. Both of these terms are explained in detail in paragraph X of this section V.

iv. *Unrealized Gain (Loss) on Securities Held.* This component of partnership capital results from the valuation of Loans and Investments by the Board of Directors or General Partner(s). Unrealized appreciation is recognized for valuations above cost and unrealized depreciation is recognized for valuations below cost. Unrealized gain or loss is the sum of the unrealized appreciation or depreciation of all Loans and Investments.

Estimated future tax effects associated with unrealized appreciation or depreciation are not taken into account because partnerships are not taxed at the entity level. For further information, see paragraph W of this section V.

VI. Availability of Publications and Forms

i. This section contains information about where to obtain various publications and forms cited in this appendix I.

ii. The following forms may be obtained from the Investment Division of SBA, 409 Third Street, SW., suite 6300, Washington, DC 20416: Form 468 (Annual Financial Report), Form 1031 (Portfolio Financing Report), and CO Form 112 (IPA Certification). Forms 468 and 1031 are provided to all Licensees in the form of electronic reporting software. SBA Policy and Procedural Releases #2001 through 2021 may also be obtained from the Investment Division.

iii. Pronouncements of the Financial Accounting Standards Board (FASB) and its predecessor, the Accounting Principles Board (APB) may be purchased from the Order Department, FASB, 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856-5116.

iv. Publications of the American Institute of Certified Public Accountants (AICPA) may be purchased from the Order Department, AICPA, Harborside Financial Center, 201 Plaza III, Jersey City, NJ 07311-3881.

3. Appendix II, Chart of accounts for SBICs, is removed and Appendix III, Valuation Guidelines for SBICs, is redesignated as Appendix II.

Dated: December 7, 1994.

Philip Lader,

Administrator.

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