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17 CFR Part 211

Staff Accounting Bulletin No. 114; Rule

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 211

[Release No. SAB 114]

Staff Accounting Bulletin No. 114

AGENCY: Securities and Exchange Commission.

ACTION: Publication of Staff Accounting Bulletin.

SUMMARY: This Staff Accounting Bulletin (SAB) revises or rescinds portions of the interpretive guidance included in the codification of the Staff Accounting Bulletin Series. This update is intended to make the relevant interpretive guidance consistent with current authoritative accounting guidance issued as part of the Financial Accounting Standards Board's Accounting Standards Codification. The principal changes involve revision or removal of accounting guidance references and other conforming changes to ensure consistency of referencing throughout the SAB Series.

DATES: *Effective Date:* March 28, 2011.

FOR FURTHER INFORMATION CONTACT: Lisa Tapley, Assistant Chief Accountant, or Annemarie Ettinger, Senior Special Counsel, Office of the Chief Accountant, at (202) 551–5300, or Craig Olinger, Deputy Chief Accountant, Division of Corporation Finance, at (202) 551–3400, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549.

SUPPLEMENTARY INFORMATION: 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: March 7, 2011.

Elizabeth M. Murphy,

Secretary.

PART 211—[AMENDED]

■ Accordingly, Part 211 of Title 17 of the Code of Federal Regulations is amended by adding Staff Accounting Bulletin No. 114 to the table found in Subpart B.

Staff Accounting Bulletin No. 114

This Staff Accounting Bulletin (SAB) revises or rescinds portions of the interpretive guidance included in the codification of the Staff Accounting Bulletin Series. This update is intended to make the relevant interpretive guidance consistent with current authoritative accounting guidance issued as part of the Financial Accounting Standards Board's Accounting Standards Codification (FASB ASC). The principal changes involve revision or removal of accounting guidance references and other conforming changes to ensure consistency of referencing throughout the SAB Series.

The following describes the changes made to the Staff Accounting Bulletin Series and certain specific topics that are presented at the end of this release:

a. The SAB Series is amended to update authoritative accounting literature references to the FASB ASC throughout. In addition, several conforming formatting changes were made for consistency across SAB topics. Due to the number of these changes, the SAB Series is represented in its entirety in this release. All of the changes are technical in nature, and none of the changes are intended to change the guidance provided in the SAB Series.

Topic 1: Financial Statements

a. Topic 1.D.1, the introductory facts are amended to conform to changes made to Items 17 and 18 of Form 20–F to reflect that certain disclosures are required only if a basis of accounting other than U.S. generally accepted accounting principles (GAAP) or International Financial Reporting Standards as issued by the International Accounting Standards Board is used. The introductory facts are also amended to remove the reference to Form F–2, as this form was eliminated effective December 1, 2005. Finally, the introductory facts are amended to reflect the foreign issuer reporting enhancements contained in SEC Release No. 33–8959.

b. Topic 1.I, the footnote previously numbered 6 within the interpretive response to question 1 is removed as the referenced guidance is now within the FASB ASC, and thus a history of the prior source is no longer relevant.

c. Topic 1.I, the footnote previously numbered 7 within the interpretive response to question 2 is removed as the term "ADC" is now defined within the body of SAB Topic 1.I.

d. Topic 1.K, the interpretive response to question 3 is amended to conform to the accounting guidance contained in FASB ASC Topic 350, Intangible Assets—Goodwill and Other. This conforming change reflects the fact that goodwill is no longer subject to amortization. The interpretive response to question 3 is also amended to replace the term "carrying value" with the term "fair value" to reflect the measurement guidance for financial assets and liabilities as stated in FASB ASC Topic 820, Fair Value Measurements and Disclosures.

e. Topic 1.K, the interpretive response to question 4, is amended to replace Item 7 of Form 8–K with Item 9.01 of Form 8–K.

Topic 3: Senior Securities

a. Topic 3.A, the interpretive response is amended to replace Rule 11–02(a)(7) of Regulation S–X with Rule 11–02(b)(7) of Regulation S–X.

Topic 5: Miscellaneous Accounting

a. Topic 5.F, the introductory facts and interpretive response are amended to replace the term "restatement" with the term "retrospective adjustment," to replace the term "restate(d)" with the term "retrospectively adjust(ed)" and to replace the term "retroactively" with the term "retrospectively" to conform to the accounting guidance contained in FASB ASC Topic 250, Accounting Changes and Error Corrections.

b. Topic 5.F, the interpretive response is amended to remove an unnecessary reference to FASB Statement No. 5 and FASB Statement No. 13.

c. Topic 5.M, the footnote previously numbered 8 within the interpretive response is removed to delete a reference which is not included in the FASB ASC.

d. Topic 5.S, the interpretive responses to questions 2, 4 (including footnote 29) and 5 are amended to revise the quoted accounting guidance to conform to the language as published in the FASB ASC. The interpretive response to question 4 is amended to remove guidance which is not included in the FASB ASC. The footnote previously numbered 31 within the interpretive response to question 4 is removed to delete a reference which is not included in the FASB ASC.

e. Topic 5.V, the interpretive response to question 1 is amended to remove an unnecessary reference to SAB Topic 5.E, as the referenced guidance in SAB Topic 5.E was removed with the issuance of SAB No. 112. As a result, the related footnote previously numbered 38 is removed.

f. Topic 5.Y, the interpretive response to question 3 is amended to remove the reference to Regulation S–B, as this Regulation was eliminated effective February 4, 2008.

g. Topic 5.Z.4, footnote 51 is amended to remove an unnecessary reference to SAB Topic 5.E.

h. Topic 5.BB, the introductory facts are amended to revise the quoted accounting guidance to conform to the language as published in the FASB ASC.

Topic 6: Interpretations of Accounting Series Releases and Financial Reporting Releases

a. Topic 6.K.3, the interpretive response is amended to conform to the accounting guidance contained in FASB ASC Topic 350, Intangible Assets—Goodwill and Other. This conforming change reflects the fact that goodwill is not amortized, but rather only tested for impairment.

b. Topic 6.L is amended throughout to update the references to the AICPA Audit and Accounting Guide, Depository and Lending Institutions with Conforming Changes as of June 1, 2009 (Audit Guide). Quoted guidance has been amended to conform to the language as published in the Audit Guide.

Topic 8: Retail Companies

a. Topic 8.A, the interpretive response is amended to remove unnecessary background information on the issuance of pre-FASB Codification standards.

Topic 13: Revenue Recognition

a. Topic 13.A.4.c, the interpretive response is amended to revise the quoted accounting guidance to conform to the language as published in the FASB ASC.

b. Topic 13.B, questions 2, 3, 4 and 5 and the interpretive responses and footnotes related to questions 2, 3, 4 and 5 are removed to eliminate unnecessary references and guidance specifically related to the original adoption of this SAB Topic.

Topic 14: Share-Based Payment

a. Topic 14.G is removed to eliminate unnecessary guidance on non-GAAP financial measures. Staff guidance on non-GAAP financial measures can be found in the Division of Corporation Finance's Compliance and Disclosure Interpretations.

b. Topics 14.H, 14.J, 14.K and 14.M are removed to eliminate unnecessary transition guidance specifically related to the first time adoption of FASB Statement No. 123(R), Share-Based Payment. Companies that had share-based payment arrangements prior to the adoption of FASB Statement No. 123(R) were required to apply this transition guidance in 2006 and therefore for these companies the guidance in Topics 14.H, 14.J, 14.K and 14.M is no longer relevant. For companies now entering into share-based payment arrangements for the first time, the guidance in FASB ASC Topic 718, Compensation—Stock Compensation, should be applied.

c. Topic 14.L is removed to conform to changes made to Items 17 and 18 of Form 20–F to reflect that reconciling items are required for disclosure only if a basis of accounting other than U.S. generally accepted accounting principles or International Financial Reporting Standards as issued by the International Accounting Standards Board is used.[

Note: The text of SAB 114 will not appear in the Code of Federal Regulations.

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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 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 (Effective for fiscal years ending on or after December 15, 2011, compliance with Item 18 rather than Item 17 will be required for all issuer financial statements in all Securities Act registration statements, Exchange Act registration statements on Form 20–F, and annual reports on Form 20–F. *See* SEC Release No. 33–8959). However, in certain circumstances, Form F–3 requires 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 for any basis other than International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB). An issuer complying with Item 18, other than those using IFRS as issued by the IASB, 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

[1] FASB ASC paragraph 740–10–30–27 (Income Taxes Topic) 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 this Subtopic. A method that allocates current and deferred taxes to members of the group by applying this Topic to each member as if it were a separate taxpayer meets those criteria."

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 FASB ASC Topic 850, Related Party Disclosures) 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. Removed 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 Accounting Series Release (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") [2] 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 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.[3] 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) [4] are audited only for the two latest fiscal years.[5] 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. Removed by Financial Reporting Release (FRR) 55

H. Removed 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 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

[2] Item 801 of Regulation S–K.

[3] Rule 3–13 of Regulation S–X.

[4] 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 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.

[5] Unaudited statements of income and cash flows should be furnished for the earliest period.

are set forth in the Acquisition, Development, and Construction Arrangements (ADC Arrangements) Subsection of FASB ASC Subtopic 310–10, Receivables—Overall.[6] [7] In September 1986 the EITF [8] reached a consensus on this issue [9] to the effect that, although the guidance in the ADC Arrangements Subsection of FASB ASC Subtopic 310–10 was issued to address the real estate ADC arrangements of financial institutions, preparers and auditors should consider that guidance in accounting for shared appreciation mortgages, loans on operating real estate and real estate ADC arrangements entered into by enterprises other than financial institutions.

FASB ASC Subtopic 815–15, Derivatives and Hedging—Embedded Derivatives, 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 expected residual profit component of an ADC arrangement need not be separately accounted for as a derivative under FASB ASC Topic 815, then the disclosure requirements discussed below for ADC loans and similar arrangements should be followed.[10]

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.[11] In addition, the ADC Arrangements Subsection of FASB ASC Subtopic 310–10 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 FASB ASC paragraph 360–20–40–18 (Property, Plant, and Equipment Topic) [12] 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 FASB ASC paragraph 360–20–40–19.[13]

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 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.[14] Accordingly, the staff believes that the financial statements of properties securing significant loans which have the characteristics of real

[6] [Original footnote removed by SAB 114.]

[7] [Original footnote removed by SAB 114.]

[8] 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.

[9] FASB ASC paragraph 310–10–05–9.

[10] The equity kicker (the expected residual profit) would typically not be separated from the host contract and accounted for as a derivative because FASB ASC subparagraph 815–15–25–1(c) 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 FASB ASC Topic 815.

[11] Expected residual profit is defined in the ADC Arrangements Subsection of FASB ASC Subtopic 310–10 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."

[12] FASB ASC Subtopic 360–20 establishes standards for the recognition of profit on real estate sales transactions. FASB ASC paragraph 360–20–40–18 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 FASB ASC paragraphs 360–20–40–55–1 and 360–20–40–55–2.

[13] FASB ASC paragraph 360–20–40–19 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.

[14] 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.

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.[15]

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 FASB ASC paragraph 360–20–40–18 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 FASB ASC paragraph 360–20–40–19. 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 provided in the ADC Arrangements Subsection of FASB ASC Subtopic 310–10. As stated in that Subsection, 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.[16] The criteria described in FASB ASC Subtopic 360–20, Property, Plant, and Equipment—Real Estate Sales, 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 FASB ASC Subtopic 360–20.

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 textural disclosure with respect to material investment-type arrangements in the "business" and "property" sections of their annual reports to the Commission.[17]

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

[15] 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."

[16] Regarding the composition of the borrower's investment, FASB ASC paragraph 310–10–25–20 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.

[17] 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.

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.[18]

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 acquisition[19] were not 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.[20]

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 months[21] 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

[18] 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.

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

[20] 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.

[21] 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.

Acquiree	Fiscal year end	Date of acquisition	Highest significance at acquisition (percent)
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	Significance of			Highest level of significance
	Assets (percent)	Earnings (percent)	Investment percent)	
A	12	23	12	23
B	10	21	10	21
C	21	3	4	21
D	10	5	13	13
E	4	*9	3	9
F	2	11	6	11

* Loss.

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% [22] 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	Period in consolidated financial statements (months)	Separate pre-acquisition audited financial statement
Registrant	N/A	33	36	
A	1/1/x7	33	24	9
B	4/1/x7	33	21	[23] 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

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.

[22] 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%).

[23] 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.

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 audited financial statements are not reasonably available.

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

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

2. Is controlled by a Federal regulatory agency; or

3. 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 (in the case of intangibles subject to amortization) 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 subject to amortization will be amortized and the period over which any discounts on acquired assets will be taken into income. If amortization of intangibles subject to amortization 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 fair 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 the instructions to Item 9.01 of Form 8–K.

L. Removed 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.[24]

Question: FASB ASC paragraph 105–10–05–6 (Generally Accepted Accounting Principles Topic) states, "The provisions of the Codification 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 omission [25] 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, Qualitative Characteristics of Accounting Information, 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.[26]

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.[27]

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.[28] Court decisions, Commission rules and enforcement actions, and accounting and auditing literature [29] have all considered "qualitative" factors in various contexts.

[24] 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 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.

[25] As used in this SAB, "misstatement" or "omission" refers to a financial statement assertion that would not be in conformity with GAAP.

[26] Concepts Statement 2, paragraph 132. *See also* Concepts Statement 2, Glossary of Terms—Materiality.

[27] *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.

[28] *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.

[29] *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 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

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.[30]

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.[31] 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.[32] The FASB also considered whether an evaluation of materiality could be based solely on anticipating the market's reaction to accounting information.[33]

The FASB rejected a formulaic approach to discharging "the onerous duty of making materiality decisions"[34] 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.[35]

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 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.[36]

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.[37]
• 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.[38] 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.[39] 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.[40]

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.[41] 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.[42] 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 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

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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).

[30] Concepts Statement 2, paragraph 131.

[31] Concepts Statement 2, paragraphs 131 and 166.

[32] Concepts Statement 2, paragraph 167.

[33] Concepts Statement 2, paragraphs 168–169.

[34] Concepts Statement 2, paragraph 170.

[35] Concepts Statement 2, paragraph 125.

[36] AU 312.11.

[37] 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.,* FASB ASC Topic 250, Accounting Changes and Error Corrections.

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

[39] *See* Concepts Statement 2, paragraph 169.

[40] 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.

[41] 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.*

[42] 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).

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.[43] "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"[44] 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.[45]

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.[46] 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."[47] This requires consideration of—

> 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.* * *[48]

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.[49]

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.[50]

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,[51] registrants must comply with Sections 13(b)(2)—(7) of the Securities Exchange Act of 1934 (the "Exchange Act").[52] Under these provisions, each registrant with

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

[44] AU 9326.33.

[45] *Id.*

[46] 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.

[47] 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 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.

[48] AU 508.36.

[49] AU 312.34.

[50] AU 380.09.

[51] FASB ASC paragraph 105–10–05–6 states that "[t]he provisions of the Codification need not be applied to immaterial items." This SAB is consistent with that provision of the Codification. In theory, this language is subject to the interpretation that the registrant is free intentionally to set forth immaterial items in 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.

[52] 15 U.S.C. 78m(b)(2)–(7).

securities registered pursuant to Section 12 of the Exchange Act,[53] or required to file reports pursuant to Section 15(d),[54] 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.[55] 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.[56] 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 guidance [57] regarding the "reasonableness" standard in Section 13(b)(2) of the Exchange Act. 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.[58] In his address, Chairman Williams noted that, like materiality, "reasonableness" is not an "absolute standard of exactitude for corporate records." [59] 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.[60]

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." [61]
- *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.[62] 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." [63]

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." [64] 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.

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

[53] 15 U.S.C. 78l.

[54] 15 U.S.C. 78o(d).

[55] 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."

[56] 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).

[57] 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).

[58] 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).

[59] *Id.* at 46 FR 11546.

[60] *Id.*

[61] 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 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).

[62] 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.

[63] *Id.,* at 11547.

[64] 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."

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, e.g.,* Statement on Auditing Standards (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 * * *"[65] 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.[66] The clear implication of SAS 99 is that immaterial misstatements may be fraudulent financial reporting.[67]

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.[68]

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.[69] 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.[70]

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.[71]

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.[72]

General Comments

This SAB is not intended to change current law or guidance in the accounting or auditing literature.[73] 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 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,

[65] 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.

[66] 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 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.

[67] 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.

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

[69] *See, e.g.,* SAS 99.

[70] 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).

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

> 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. * * *

[72] *See* AU 411.05.

[73] 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.

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.

N. Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements

(Added by SAB 108)

Facts: During the course of preparing annual financial statements, a registrant is evaluating the materiality of an improper expense accrual (*e.g.,* overstated liability) in the amount of $100, which has built up over 5 years, at $20 per year.[74] The registrant previously evaluated the misstatement as being immaterial to each of the prior year financial statements (*i.e.,* years 1–4). For the purpose of evaluating materiality in the current year (*i.e.,* year 5), the registrant quantifies the error as a $20 overstatement of expenses.

Question 1: Has the registrant appropriately quantified the amount of this error for the purpose of evaluating materiality for the current year?

Interpretive Response: No. In this example, the registrant has only quantified the effects of the identified unadjusted error that arose in the current year income statement. The staff believes a registrant's materiality evaluation of an identified unadjusted error should quantify the effects of the identified unadjusted error on each financial statement and related financial statement disclosure.

Topic 1M notes that a materiality evaluation must be based on all relevant quantitative and qualitative factors.[75] This analysis generally begins with quantifying potential misstatements to be evaluated. There has been diversity in practice with respect to this initial step of a materiality analysis.

The diversity in approaches for quantifying the amount of misstatements primarily stems from the effects of misstatements that were not corrected at the end of the prior year ("prior year misstatements"). These prior year misstatements should be considered in quantifying misstatements in current year financial statements.

The techniques most commonly used in practice to accumulate and quantify misstatements are generally referred to as the "rollover" and "iron curtain" approaches.

The rollover approach, which is the approach used by the registrant in this example, quantifies a misstatement based on the amount of the error originating in the current year income statement. Thus, this approach ignores the effects of correcting the portion of the current year balance sheet misstatement that originated in prior years (*i.e.,* it ignores the "carryover effects" of prior year misstatements).

The iron curtain approach quantifies a misstatement based on the effects of correcting the misstatement existing in the balance sheet at the end of the current year, irrespective of the misstatement's year(s) of origination. Had the registrant in this fact pattern applied the iron curtain approach, the misstatement would have been quantified as a $100 misstatement based on the end of year balance sheet misstatement. Thus, the adjustment needed to correct the financial statements for the end of year error would be to reduce the liability by $100 with a corresponding decrease in current year expense.

As demonstrated in this example, the primary weakness of the rollover approach is that it can result in the accumulation of significant misstatements on the balance sheet that are deemed immaterial in part because the amount that originates in each year is quantitatively small. The staff is aware of situations in which a registrant, relying on the rollover approach, has allowed an erroneous item to accumulate on the balance sheet to the point where eliminating the improper asset or liability would itself result in a material error in the income statement if adjusted in the current year. Such registrants have sometimes concluded that the improper asset or liability should remain on the balance sheet into perpetuity.

In contrast, the primary weakness of the iron curtain approach is that it does not consider the correction of prior year misstatements in the current year (*i.e.,* the reversal of the carryover effects) to be errors. Therefore, in this example, if the misstatement was corrected during the current year such that no error existed in the balance sheet at the end of the current year, the reversal of the $80 prior year misstatement would not be considered an error in the current year financial statements under the iron curtain approach. Implicitly, the iron curtain approach assumes that because the prior year financial statements were not materially misstated, correcting any immaterial errors that existed in those statements in the current year is the "correct" accounting, and is therefore not considered an error in the current year. Thus, utilization of the iron curtain approach can result in a misstatement in the current year income statement not being evaluated as an error at all.

The staff does not believe the exclusive reliance on either the rollover or iron curtain approach appropriately quantifies all misstatements that could be material to users of financial statements.

In describing the concept of materiality, Concepts Statement 2, Qualitative Characteristics of Accounting Information, indicates that materiality determinations are based on whether "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*" (emphasis added).[76] The staff believes registrants must quantify the impact of correcting all misstatements, including both the carryover and reversing effects of prior year misstatements, on the current year financial statements. The staff believes that this can be accomplished by quantifying an error under both the rollover and iron curtain approaches as described above and by evaluating the error measured under each approach. Thus, a registrant's financial statements would require adjustment when either approach results in quantifying a misstatement that is material, after considering all relevant quantitative and qualitative factors.

As a reminder, a change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error.[77]

The staff believes that the registrant should quantify the current year misstatement in this example using both the iron curtain approach (*i.e.,* $100) and the rollover approach (*i.e.,* $20). Therefore, if the $100 misstatement is considered material to the financial statements, after all of the relevant quantitative and qualitative factors are considered, the registrant's financial statements would need to be adjusted.

It is possible that correcting an error in the current year could materially misstate the current year's income statement. For example, correcting the

[74] For purposes of these facts, assume the registrant properly determined that the overstatement of the liability resulted from an error rather than a change in accounting estimate. *See* the FASB ASC Master Glossary for the distinction between an error in previously issued financial statements and a change in accounting estimate.

[75] Topic 1N addresses certain of these quantitative issues, but does not alter the analysis required by Topic 1M.

[76] Concepts Statement 2, paragraph 132. *See also* Concepts Statement 2, Glossary of Terms—Materiality.

[77] *See* definition of "error in previously issued financial statements" in the FASB ASC Master Glossary.

$100 misstatement in the current year will:

- Correct the $20 error originating in the current year;
- Correct the $80 balance sheet carryover error that originated in Years 1 through 4; but also
- Misstate the current year income statement by $80.

If the $80 understatement of current year expense is material to the current year, after all of the relevant quantitative and qualitative factors are considered, the prior year financial statements should be corrected, even though such revision previously was and continues to be immaterial to the prior year financial statements. Correcting prior year financial statements for immaterial errors would not require previously filed reports to be amended. Such correction may be made the next time the registrant files the prior year financial statements.

The following example further illustrates the staff's views on quantifying misstatements, including the consideration of the effects of prior year misstatements:

Facts: During the course of preparing annual financial statements, a registrant is evaluating the materiality of a sales cut-off error in which $50 of revenue from the following year was recorded in the current year, thereby overstating accounts receivable by $50 at the end of the current year. In addition, a similar sales cut-off error existed at the end of the prior year in which $110 of revenue from the current year was recorded in the prior year. As a result of the combination of the current year and prior year cut-off errors, revenues in the current year are understated by $60 ($110 understatement of revenues at the beginning of the current year partially offset by a $50 overstatement of revenues at the end of the current year). The prior year error was evaluated in the prior year as being immaterial to those financial statements.

Question 2: How should the registrant quantify the misstatement in the current year financial statements?

Interpretive Response: The staff believes the registrant should quantify the current year misstatement in this example using both the iron curtain approach (*i.e.,* $50) and the rollover approach (*i.e.,* $60). Therefore, assuming a $60 misstatement is considered material to the financial statements, after all relevant quantitative and qualitative factors are considered, the registrant's financial statements would need to be adjusted.

Further, in this example, recording an adjustment in the current year could alter the amount of the error affecting the current year financial statements. For instance:

- If only the $60 understatement of revenues were to be corrected in the current year, then the overstatement of current year end accounts receivable would increase to $110; or,
- If only the $50 overstatement of accounts receivable were to be corrected in the current year, then the understatement of current year revenues would increase to $110.

If the misstatement that exists after recording the adjustment in the current year financial statements is material (considering all relevant quantitative and qualitative factors), the prior year financial statements should be corrected, even though such revision previously was and continues to be immaterial to the prior year financial statements. Correcting prior year financial statements for immaterial errors would not require previously filed reports to be amended. Such correction may be made the next time the registrant files the prior year financial statements.

If the cut-off error that existed in the prior year was not discovered until the current year, a separate analysis of the financial statements of the prior year (and any other prior year in which previously undiscovered errors existed) would need to be performed to determine whether such prior year financial statements were materially misstated. If that analysis indicates that the prior year financial statements are materially misstated, they would need to be restated in accordance with FASB ASC Topic 250, Accounting Changes and Error Corrections.[78]

Facts: When preparing its financial statements for years ending on or before November 15, 2006, a registrant quantified errors by using either the iron curtain approach or the rollover approach, but not both. Based on consideration of the guidance in this Staff Accounting Bulletin, the registrant concludes that errors existing in previously issued financial statements are material.

Question 3: Will the staff expect the registrant to restate prior period financial statements when first applying this guidance?

Interpretive Response: The staff will not object if a registrant[79] does not restate financial statements for fiscal years ending on or before November 15, 2006, if management properly applied its previous approach, either iron curtain or rollover, so long as all relevant qualitative factors were considered.

To provide full disclosure, registrants electing not to restate prior periods should reflect the effects of initially applying the guidance in Topic 1N in their annual financial statements covering the first fiscal year ending after November 15, 2006. The cumulative effect of the initial application should be reported in the carrying amounts of assets and liabilities as of the beginning of that fiscal year, and the offsetting adjustment should be made to the opening balance of retained earnings for that year. Registrants should disclose the nature and amount of each individual error being corrected in the cumulative adjustment. The disclosure should also include when and how each error being corrected arose and the fact that the errors had previously been considered immaterial.

Early application of the guidance in Topic 1N is encouraged in any report for an interim period of the first fiscal year ending after November 15, 2006, filed after the publication of this Staff Accounting Bulletin. In the event that the cumulative effect of application of the guidance in Topic 1N is first reported in an interim period other than the first interim period of the first fiscal year ending after November 15, 2006, previously filed interim reports need not be amended. However, comparative information presented in reports for interim periods of the first year subsequent to initial application should be adjusted to reflect the cumulative effect adjustment as of the beginning of the year of initial application. In addition, the disclosures of selected quarterly information required by Item 302 of Regulation S–K should reflect the adjusted results.

TOPIC 2: BUSINESS COMBINATIONS

A. Acquisition Method

1. Removed by SAB 103

2. Removed by SAB 103

3. Removed by SAB 103

4. Removed by SAB 103

5. Removed by SAB 112

6. Debt Issue Costs

Facts: Company A is to acquire the net assets of Company B in a transaction

[78] FASB ASC paragraph 250–10–45–23.

[79] If a registrant's initial registration statement is not effective on or before November 15, 2006, and the registrant's prior year(s) financial statements are materially misstated based on consideration of the guidance in this Staff Accounting Bulletin, the prior year financial statements should be restated in accordance with FASB ASC paragraph 250–10–45–23. If a registrant's initial registration statement is effective on or before November 15, 2006, the guidance in the interpretive response to Question 3 is applicable.

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: Should total fees paid to the investment banker for acquisition-related services and the issuance of debt securities be allocated between the services received?

Interpretive Response: Yes. Fees paid to an investment banker in connection with a business combination or asset acquisition, when the investment banker is also providing interim financing or underwriting services, must be allocated between acquisition related services and debt issue costs.

When an investment banker provides services in connection with a business combination or asset acquisition and also provides underwriting services associated with the issuance of debt or equity securities, the total fees incurred by an entity should be allocated between the services received on a relative fair value basis. The objective of the allocation is to ascribe the total fees incurred to the actual services provided by the investment banker.

FASB ASC Topic 805, Business Combinations, provides guidance for the portion of the costs that represent acquisition-related services. The portion of the costs pertaining to the issuance of debt or equity securities should be accounted for in accordance with other applicable GAAP.

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?

1. *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 guidance issued in FASB ASC Topic 470, Debt, should be followed.[1]

7. Removed by SAB 112

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 FASB ASC Topic 805. Accordingly, the staff believes that the combination of two or more businesses should be accounted for in accordance with FASB ASC Topic 805.

9. Removed by SAB 112

B. Removed by SAB 103

C. Removed 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 (or entities) or property (or properties) are deemed to constitute a business.

One financial reporting issue in exchange transactions involves deciding which prior financial results of the entities should be reported.

Question 1: In Form 10–K filings with the Commission, the staff has permitted limited partnerships to omit certain of the oil and gas reserve value information and the supplemental summary of oil and gas activities disclosures required by FASB ASC Subtopic 932–235, Extractive Activities—Oil and Gas—Notes to Financial Statements, 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 exchange offers.[2] These disclosures may, however, be presented on a combined basis if the entities are under common control.

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 using the acquisition method of accounting, 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.

[1] As noted in FASB ASC paragraph 470–10–35–2, 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 FASB ASC Topic 815, Derivatives and Hedging.

[2] *See* SAB 40, Topic 12.A.3.c.

Question 2: 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 3: How should "common control accounting" be applied to the specific assets and liabilities of the new exchange company?

Interpretive Response: Consistent with SAB Topic 12.C.2, 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, 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 retrospectively.

Question 4: 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.[3] 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 transaction among entities under common control, historical depreciation, depletion and amortization provisions may be aggregated, with appropriate disclosure.

(4) Reflect the acquisition in the pro forma statements where the exchange offer is accounted for using the acquisition method of accounting, including depreciation, depletion and amortization based on the measurement guidance in FASB ASC Topic 805, Business Combinations.

(5) Provide pro forma reserve information comparable to the disclosures required by FASB ASC paragraphs 932–235–50–3 through 932–235–50–11B and FASB ASC paragraphs 932–235–50–29 through 932–235–50–36.

(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 5: 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 Regulation 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. Acquisition Method Accounting

1. If the registrant can demonstrate that full historical financial statements of the offeree businesses 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 offerees 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 offerees had no material quantity of production.

B. Common Control Accounting

The staff would expect that 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 transactions among entities under common control, 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. Removed by SAB 103

F. Removed 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(b)(7) of Regulation S–X, if material.

B. Removed by ASR 307

C. Redeemable Preferred Stock

Facts: Rule 5–02.27 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

[3] As announced in Financial Reporting Release No. 2 (July 9, 1982).

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 FASB ASC paragraph 480–10–S99–3A (Distinguishing Liabilities from Equity Topic).

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 consideration [1] 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 FASB ASC Topic 260, Earnings Per Share, the staff believed that certain stock and warrants [2] 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 FASB ASC Topic 260?

Interpretive Response: Generally, no. Historical EPS should be prepared and presented in conformity with FASB ASC Topic 260.

In applying the requirements of FASB ASC Topic 260, 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 FASB ASC paragraph 260–10–55–12. In computing diluted EPS for such periods, nominal issuances of common stock and potential common stock [3] 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 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

[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 encompasses 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.

[3] The FASB ASC Master Glossary 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."

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: Capital stock is sometimes issued to officers or other employees before the cash payment is received.

Question: How should the receivables from the officers or other employees be presented in the balance sheet?

Interpretive Response: The amount recorded as a receivable 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 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.

[4] As prescribed by FASB ASC Topic 718, Compensation—Stock Compensation.

C.1. Removed by SAB 103

C.2. Removed 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: If deconsolidation of the subsidiaries and business operations is appropriate, can Company X recognize a gain?

Interpretive Response: Before recognizing any gain, Company X should identify all of the elements of the divesture arrangement and allocate the consideration exchanged to each of those elements. In this regard, we believe that Company X would recognize the guarantees at fair value in accordance with FASB ASC Topic 460, Guarantees; the contingent liability for performance on existing contracts in accordance with FASB ASC Topic 450, Contingencies; and the promissory notes in accordance with FASB ASC Topic 310, Receivables, and FASB ASC Topic 835, Interest.

F. Accounting Changes Not Retroactively Applied Due to Immateriality

Facts: A registrant is required to adopt an accounting principle by means of retrospective adjustment 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 retrospectively adjust 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 retrospectively adjusted, the cumulative effect of the change should be included in the statement of income for the period in which the change is made. 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 retrospectively adjusted.

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 FASB ASC paragraph 845–10–15–4 (Nonmonetary Transactions Topic) states that the guidance in this topic 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 issued [1] 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. Removed by SAB 112

I. Removed by SAB 70

J. New Basis of Accounting Required in Certain 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 B's separate financial statements should reflect the new basis of accounting recorded by Company A upon acquisition (*i.e.,* "pushed down" basis).

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 noncontrolling 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.

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 FASB ASC Topic 450, Contingencies, FASB ASC Topic 850, Related Party Disclosures, and FASB ASC Topic 460, Guarantees, 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 assets [6] 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

[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.

[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 Company 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."

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. Removed 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.[7] 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 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 FASB ASC Topic 250, Accounting Changes and Error Corrections, 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 Equity Securities

Facts: FASB ASC paragraph 320–10–35–33 (Investments—Debt and Equity Securities Topic) does not define the phrase "other than temporary" for available-for-sale equity securities. For its available-for-sale equity securities, 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's equity securities is permanently impaired, no realized loss has been recognized even though the market price of Company B's equity securities is currently less than one-third of Company A's average acquisition price.

Question: For equity securities classified as available-for-sale, 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.[8]

The value of investments in equity securities classified as available-for-sale 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 in equity securities classified as available-for-sale.

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

[7] 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 * * *"

[8] [Original footnote removed by SAB 114.]

following are only a few examples of the factors which, individually or in combination, indicate that a decline in value of an equity security classified as available-for-sale 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 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 in equity securities classified as available-for-sale, a write-down to fair value accounted for as a realized loss should be recorded. 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-duration [9] 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

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

(1) The payment pattern and ultimate cost are fixed and determinable on an individual claim basis, and

(2) 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 FASB ASC Topic 250, Accounting Changes and Error Corrections. Initial adoption of discounting for GAAP purposes would be treated similarly. In either case, in addition to the disclosures required by FASB ASC Topic 250 concerning the change in accounting principle, a preferability letter from the registrant's independent accountant is required.

O. Research and Development Arrangements

Facts: FASB ASC paragraph 730–20–25–5 (Research and Development Topic) 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. FASB ASC subparagraph 730–20–25–6(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 FASB ASC subparagraph 730–20–25–6(c)?

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.[10] 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: FASB ASC paragraph 730–20–25–5 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. FASB ASC paragraph 730–20–25–3 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. Removed by SAB 103

2. Removed 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.

[9] The term "short-duration" refers to the period of coverage (*see* FASB ASC paragraph 944–20–15–7 (Financial Services—Insurance Topic)), not the period that the liabilities are expected to be outstanding.

[10] Related parties as used herein are as defined in the FASB ASC Master Glossary.

Additionally, since the charges are not both unusual and infrequent[11] 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. FASB ASC paragraph 225–20–45–16 (Income Statement Topic) 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.[12] Neither FASB ASC Subtopic 225–20, Income Statement—Extraordinary and Unusual Items, 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 sub-total 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 FASB ASC Subtopic 225–20.

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 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, FASB ASC Topic 420, Exit or Disposal Cost Obligations, 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 FASB ASC Topic 420 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 charges[13] 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 benefits[14] (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

[11] *See* FASB ASC paragraph 225–20–45–2.

[12] FASB ASC paragraph 225–20–45–16 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.

[13] 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.

[14] The staff would expect similar disclosures for employee termination benefits whether those costs have been recognized pursuant to FASB ASC Topic 420, FASB ASC Topic 712, Compensation—Nonretirement Postemployment Benefits, or FASB ASC Topic 715, Compensation—Retirement Benefits.

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:

1. When the registrant began formulating exit plans for which accrual may be necessary,
2. The types and amounts of liabilities recognized for exit costs and involuntary employee termination benefits and included in the acquisition cost allocation, and
3. 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 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 stock [15] 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 $79⅜ per share. The difference, $20⅝, 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.[16] 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

[15] "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.

[16] As described in the "Facts" section of this 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 the 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.

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,[17] 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 $100[18] 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 FASB ASC Subtopic 835–30, Interest—Imputation of Interest, and Topic 3.C of this codification for unstated interest costs of debt capital and unstated dividend costs of redeemable preferred stock capital, 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 redeemable [19] 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.[20] 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. Removed 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

[17] *See* Question 3 regarding variable increasing rate preferred stocks.

[18] 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 a nonredeemable preferred stock being accreted to its par value, stated value, voluntary redemption value or involuntary liquidation value.

[19] 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 FASB ASC Subtopic 835–30, produces a constant effective periodic rate of cost that is comprised of amortization of discount as well as the stated cost in each period.

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

accounting principles [21] 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 210 [22] 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 210 [23] for a quasi-reorganization are satisfied. [24]

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. [25]

FASB ASC paragraph 852–20–25–5 (Reorganizations Topic) indicates that, following a quasi-reorganization, an "entity's accounting shall be substantially similar to that appropriate for a new entity." 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.[26] FASB ASC paragraph 852–20–30–2 states, in part, "* * * in general, assets should be carried forward as of the date of the readjustment at fair and not unduly conservative amounts, *determined with due regard for the accounting to be subsequently employed by the entity.*" (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.[27]

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 is 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.[28] 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 FASB ASC Subtopic 852–740, Reorganizations—Income Taxes, 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,[29] 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. [30]

The staff believes that all registrants that comply with the requirements of Section 210 in effecting a quasi-

[21] 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.

[22] ASR 25.

[23] 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;

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.

[24] In addition, FASB ASC Subtopic 852–20, Reorganizations—Quasi-Reorganizations, outlines procedures that must be followed in connection with and after a quasi-reorganization.

[25] FASB ASC Topic 250 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.

[26] 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.

[27] 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.

[28] *See* footnote 27.

[29] 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)

[30] FASB ASC paragraph 852–740–55–4 states in part: "As indicated in paragraph 852–20–25–5, after a quasi-reorganization, the entity's accounting shall be substantially similar to that appropriate for a new entity. As such, any subsequently recognized tax benefit of an operating loss or tax credit carryforward that existed at the date of a quasi-reorganization shall not be included in the determination of income of the "new" entity, regardless of whether losses that gave rise to an operating loss carryforward were charged to income before the quasi-reorganization or directly to contributed capital as part of the quasi-reorganization. A new entity would not have tax benefits attributable to operating losses or tax credits that arose before its organization date."

reorganization should apply the accounting required by FASB ASC paragraph 852–740–45–3 for the tax benefits of tax carryforward items.[31, 32] 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 FASB ASC Topic 250, Accounting Changes and Error Corrections, would preclude such a change in accounting. It states: "a method of accounting that was previously adopted for a type of transaction or event that is being terminated *or that was a single, nonrecurring event in the past shall not be changed*." (emphasis added.) [33]

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

(Replaced by SAB 107)

Facts: Company X was a defendant in litigation for which the company had not recorded a liability in accordance with FASB ASC Topic 450, Contingencies. A principal stockholder [34] 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 FASB ASC paragraph 718–10–15–4 (Compensation—Stock Compensation Topic), which states that "share-based payments awarded to an employee of the reporting entity by a related party or other holder of an economic interest [35] in the entity as compensation for services provided to the entity are share-based payment transactions to be accounted for under this Topic unless the transfer is clearly for a purpose other than compensation for services to the reporting entity." As explained in this paragraph, the substance of such a transaction is that the economic interest holder makes a capital contribution to the reporting entity, and the reporting entity makes a share-based payment to its employee in exchange for services rendered.

The staff believes that the problem of separating the benefit to the principal stockholder from the benefit to the company cited in FASB ASC Topic 718 is not limited to transactions involving stock compensation. Therefore, similar accounting is required in this and other [36] 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 FASB ASC Topic 850, Related Party Disclosures, applies to these transactions and requires only the disclosure of material related party transactions, the staff should not analogize to the accounting called for by FASB ASC paragraph 718–10–15–4 for transactions other than those specifically covered by it. The staff notes, however, that FASB ASC Topic 850 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.[37] However, the staff believes that transactions of the type described above differ from the typical related party transactions.

The transactions for which FASB ASC Topic 850 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 believes it would be inappropriate to account for such transactions according to the form of the transaction.

U. Removed by SAB 112

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

31 [Original footnote removed by SAB 114.]

32 FASB ASC paragraph 852–740–45–3 states: "[t]he tax benefit of deductible temporary differences and carryforwards as of the date of a quasi reorganization as defined and contemplated in FASB ASC Subtopic 852–20, ordinarily are reported as a direct addition to contributed capital if the tax benefits are recognized in subsequent years."

33 FASB ASC paragraph 250–10–45–12.

34 The FASB ASC Master Glossary defines principal owners as "owners of record or known beneficial owners of more than 10 percent of the voting interests of the enterprise."

35 The FASB ASC Master Glossary defines an economic interest in an entity as "any type or form of pecuniary interest or arrangement that an entity could issue or be a party to, including equity securities; financial instruments with characteristics of equity, liabilities or both; long-term debt and other debt-financing arrangements; leases; and contractual arrangements such as management contracts, service contracts, or intellectual property licenses." Accordingly, a principal stockholder would be considered a holder of an economic interest in an entity.

36 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.

37 However, in some circumstances it is necessary to reflect, either in the historical financial 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).

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.

FASB ASC Topic 860, Transfers and Servicing, 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 FASB ASC Topic 860. Because FASB ASC Topic 860 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 ASC Topic 810, Consolidation, 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.[38] 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,[39] 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 value [40] over the fair value.[41] Fair value is the amount that would be realizable in an outright sale to an unrelated third party for cash.[42] 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

[38] [Original footnote removed by SAB 114.]

[39] 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.

[40] 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.

[41] The staff notes that FASB ASC paragraph 942–810–45–2 (Financial Services—Depository and Lending Topic) provides guidance that the newly created "liquidating bank" should continue to report its assets and liabilities at fair values at the date of the financial statements.

[42] FASB ASC paragraph 845–10–30–14 (Nonmonetary Transactions Topic) provides guidance that an enterprise that distributes loans to its owners should report such distribution at fair value.

redeemable instrument, careful consideration must be given to the appropriateness of recording profits on the management fee arrangement, 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.[43]

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 FASB ASC Topic 944, Financial Services—Insurance, for unpaid claim costs, including estimates of costs relating to claims incurred but not reported ("IBNR").[44] 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.

FASB ASC Topic 450, Contingencies, requires, among other things, disclosure of loss contingencies.[45] However, FASB ASC paragraph 450–10–05–6 notes that "[n]ot all uncertainties inherent in the accounting process give rise to contingencies."

FASB ASC Topic 275, Risks and Uncertainties,[46] also provides disclosure guidance regarding certain significant estimates.

Question 1: In the staff's view, do FASB ASC Topics 450 and 275 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 contingencies [47] for purposes of applying FASB ASC Topics 450 and 275 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 FASB ASC Topic 450. Some specific uncertainties that may result in loss contingencies pursuant to FASB ASC Topic 450, 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 FASB ASC Topic 275 apply when "[i]t is at least reasonably possible that the estimate of 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 FASB ASC Topics 450 and 275?

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 FASB ASC Topics 450 and 275. 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,

[43] 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.

[44] FASB ASC paragraph 944–40–30–1 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]

[45] FASB ASC paragraphs 450–20–50–3 through 450–20–50–4 provide guidance that if no accrual is made for a loss contingency because one or both of the conditions in FASB ASC paragraph 450–20–25–2 are not met, *or if an exposure to loss exists in excess of the amount accrued* pursuant to the provisions of FASB ASC paragraph 450–20–25–2, 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.]

[46] FASB ASC Topic 275 provides that disclosures regarding certain significant estimates should be made when certain criteria are met. The guidance provides that the disclosure shall 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 FASB ASC Topic 450, 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.

FASB ASC Topic 275 requires disclosures regarding current vulnerability due to certain concentrations which may be applicable as well.

[47] The loss contingency referred to in this document is the potential for a material understatement of reserves for unpaid claims.

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 FASB ASC Topics 450 and 275 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. Removed 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 FASB ASC paragraph 410–30–35–12 (Asset Retirement and Environmental Obligations Topic) 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. Further, the discount rate used to discount the cash payments should not exceed the interest rate on monetary assets that are essentially risk free [48] 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: FASB ASC Section 450–20–50, Contingencies—Loss Contingencies—Disclosure, identify disclosures regarding loss contingencies that generally are furnished in notes to financial statements. FASB ASC Section 410–30–50, Asset Retirement and Environmental Obligations—Environmental Obligations—Disclosure, 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 FASB ASC Section 450–20–50 and FASB ASC Section 410–30–50, 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 disclosure of any material limitations of that recovery.
- Uncertainties regarding the legal sufficiency of insurance claims or solvency of insurance carriers.[49]
- 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 FASB ASC Topic 450 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 Regulation S–K. The Commission has issued interpretive releases that provide additional guidance with respect to these items.[50] 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.[51] 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

[48] As described in Concepts Statement 7, Using Cash Flow Information and Present Value in Accounting Measurements.

[49] 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.

[50] *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.

[51] *See, e.g.,* footnote 30 of FR 36 (footnote 17 of Section 501.02 of the Codification of Financial Reporting Policies).

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? [52]

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.[53] The registrant's accounting policy with respect to such costs should be disclosed in accordance with FASB ASC Topic 235, Notes to Financial Statements.

Z. Accounting and Disclosure Regarding Discontinued Operations

1. Removed by SAB 103

2. Removed by SAB 103

3. Removed 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 the FASB ASC Master Glossary. 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 FASB ASC Subtopic 323–10, Investments—Equity Method and Joint Ventures—Overall, to account for its residual investment using the equity method.[54]

Question: May the historical operating results of the component and the gain or 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 FASB ASC Subtopic 205–20, Presentation of Financial Statements—Discontinued Operations?

Interpretive Response: No. A condition necessary for discontinued operations reporting, as indicated in FASB ASC paragraph 205–20–45–1 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 FASB ASC paragraph 360–10–45–5 (Property, Plant, and Equipment Topic).[55]

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 FASB ASC Subtopic 205–20 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

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[52] Registrants are reminded that FASB ASC Subtopic 410–20, Asset Retirement and Environmental Obligations—Asset Retirement Obligations, provides guidance for accounting and reporting for costs associated with asset retirement obligations.

[53] If the company has a guarantee as defined by FASB ASC Topic 460, Guarantees, 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.

[54] In some circumstances, the seller's continuing interest may be so great that divestiture accounting is inappropriate.

[55] 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.

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.[56] 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.

FASB ASC paragraph 205–20–45–4 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 FASB ASC paragraph 205–20–45–4 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 FASB ASC paragraph 205–20–45–4. 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&A [57] 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,[58] 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 FASB ASC Topic 450, Contingencies. 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. Removed 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 an investment in the subsidiary, in the manner specified by FASB ASC Topic 250, Accounting Changes and Error Corrections?

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 FASB ASC Topic 360. 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 FASB ASC paragraph 280–10–50–10 (Segment Reporting Topic).

[56] Registrants are reminded that FASB ASC Topic 460, Guarantees, requires recognition and disclosure of certain guarantees which may impose accounting and disclosure requirements in addition to those discussed in this SAB Topic.

[57] Item 303 of Regulation S–K.

[58] Registrants also should consider the disclosure requirements of FASB ASC Topic 460.

AA. Removed by SAB 103

BB. Inventory Valuation Allowances

Facts: FASB ASC paragraph 330–10–35–1 (Inventory Topic), 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 deterioration, obsolescence, changes in price levels, or other causes, the difference shall 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."

FASB ASC paragraph 330–10–35–14 indicates that "[i]n the case of goods which have been written down below cost at the close of a fiscal year, such reduced amount is to be considered the cost for subsequent accounting purposes."

Lastly, the FASB ASC Master Glossary provides "inventory obsolescence" as one of the items subject to a change in accounting estimate.

Question: Does the write-down of inventory to the lower of cost or market, as required by FASB ASC Topic 330, 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 FASB ASC paragraph 330–10–35–14, 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.[59]

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 FASB ASC Topic 360, Property, Plant, and Equipment. 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 FASB ASC Topic 350, Intangibles—Goodwill and Other.

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 FASB ASC Topic 360 for the carrying value of the mainframe computers of $4,600 in March 20X3. Does Company X meet the requirements in FASB ASC Topic 360 to classify the mainframe computer assets as "to be abandoned?"

Interpretive Response: No. FASB ASC paragraph 360–10–35–47 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 FASB ASC Topic 250, Accounting Changes and Error Corrections, 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 FASB ASC Topic 360 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. FASB ASC paragraph 360–10–35–43 requires the asset to be valued at the lower of carrying amount or fair value less cost to sell in order to be classified as "held for sale." For assets that are classified as "held and used" under FASB ASC Topic 360, an assessment must first be made as to whether the asset (asset group) is impaired. FASB ASC paragraph 360–10–35–17 indicates that an impairment loss shall be recognized only if the carrying amount of a long-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 FASB ASC Topic 360.

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

[59] *See also* disclosure requirement for inventory balances in Rule 5–02(6) of Regulation S–X.

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 FASB ASC Topic 360?

Interpretive Response: In providing guidance on the development of cash flows for purposes of applying the provisions of that Topic, FASB ASC paragraph 360–10–35–30 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 FASB ASC Topic 360. The staff, however, cautions registrants that the judgments and assumptions made for purposes of applying FASB ASC Topic 360 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 FASB ASC Topic 360 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 FASB ASC Topic 360 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 FASB ASC Topic 740, Income Taxes. 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.

DD. Written Loan Commitments Recorded at Fair Value Through Earnings

Facts: Bank A enters into a loan commitment with a customer to originate a mortgage loan at a specified rate. As part of this written loan commitment, Bank A expects to receive future net cash flows related to servicing rights from servicing fees (included in the loan's interest rate or otherwise), late charges, and other ancillary sources, or from selling the servicing rights to a third party. If Bank A intends to sell the mortgage loan after it is funded, pursuant to FASB ASC paragraph 815–10–15–83 (Derivatives and Hedging Topic), the written loan commitment is accounted for as a derivative instrument and recorded at fair value through earnings (referred to hereafter as a "derivative loan commitment"). If Bank A does not intend to sell the mortgage loan after it is funded, the written loan commitment is not accounted for as a derivative under FASB ASC Subtopic 815–10, Derivatives and Hedging—Overall. However, FASB ASC subparagraph 825–10–15–4(c) (Financial Instruments Topic) permits Bank A to record the written loan commitment at fair value through earnings (referred to hereafter as a "written loan commitment"). Pursuant to FASB ASC Subtopic 825–10, Financial Instruments—Overall, the fair value measurement for a written loan commitment would include the expected net future cash flows related to the associated servicing of the loan.

Question 1: In measuring the fair value of a derivative loan commitment accounted for under FASB ASC Subtopic 815–10, should Bank A include the expected net future cash flows related to the associated servicing of the loan?

Interpretive Response: Yes. The staff believes that, consistent with the guidance in FASB ASC Subtopic 860–50, Transfers and Servicing—Servicing Assets and Liabilities,[60] and FASB ASC Subtopic 825–10, the expected net future cash flows related to the associated servicing of the loan should be included in the fair value measurement of a derivative loan commitment. The expected net future cash flows related to the associated servicing of the loan that are included in the fair value measurement of a derivative loan commitment or a written loan commitment should be determined in the same manner that the fair value of a recognized servicing asset or liability is measured under FASB ASC Subtopic 860–50. However, as discussed in FASB ASC paragraph 860–50–25–1, a separate and distinct servicing asset or liability is not recognized for accounting purposes until the servicing rights have been contractually separated from the underlying loan by sale or securitization of the loan with servicing retained.

The views in Question 1 apply to all loan commitments that are accounted for at fair value through earnings. However, for purposes of electing fair value accounting pursuant to FASB ASC Subtopic 825–10, the views in Question 1 are not intended to be applied by analogy to any other instrument that contains a nonfinancial element.

Question 2: In measuring the fair value of a derivative loan commitment accounted for under FASB ASC Subtopic 815–10 or a written loan commitment accounted for under FASB ASC Subtopic 825–10, should Bank A include the expected net future cash flows related to internally-developed intangible assets?

Interpretive Response: No. The staff does not believe that internally-developed intangible assets (such as customer relationship intangible assets) should be recorded as part of the fair value of a derivative loan commitment or a written loan commitment. Such

[60] FASB ASC Subtopic 860–50 permits an entity to subsequently measure recognized servicing assets and servicing liabilities (which are nonfinancial instruments) at fair value through earnings.

nonfinancial elements of value should not be considered a component of the related instrument. Recognition of such assets would only be appropriate in a third-party transaction. For example, in the purchase of a portfolio of derivative loan commitments in a business combination, a customer relationship intangible asset is recorded separately from the fair value of such loan commitments. Similarly, when an entity purchases a credit card portfolio, FASB ASC paragraph 310–10–25–7 (Receivables Topic) requires an allocation of the purchase price to a separately recorded cardholder relationship intangible asset.

The view in Question 2 applies to all loan commitments that are accounted for at fair value through earnings.

TOPIC 6: INTERPRETATIONS OF ACCOUNTING SERIES RELEASES AND FINANCIAL REPORTING RELEASES

A.1. Removed 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 statement [1] when it is materially different in quantitative terms from reported net income or loss [2] 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).

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. Removed by SAB 103

G. Accounting Series Releases 177 and 286—Relating to Amendments to Form 10–Q, Regulation S–K, and Regulations 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.[3] 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. 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 (loss), net income (loss), and net income (loss) attributable to the registrant 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 entity [4] 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

[1] When a registrant reports net income and total comprehensive income in one continuous financial statement, 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.

[3] 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.

[4] *See* question 5 for a discussion of the meaning of components of an entity as used in Item 302(a)(2).

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 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 FASB ASC Subtopic 205–20, Presentation of Financial Statements—Discontinued Operations, 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 FASB ASC paragraph 270–10–50–2 (Interim Reporting Topic) which relates to disclosures required for the fourth quarter of the year. FASB ASC Topic 270 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. Removed 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 attributable to the registrant 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: 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 3: 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.

b. 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.[5]

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 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 the Accounting Standards Codification, 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

[5] Registrants also are reminded that FASB ASC paragraph 250–10–50–1 (Accounting Changes and Error Corrections Topic) 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.

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 FASB ASC Subtopic 470–10, Debt—Overall, 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
Computation:	
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.

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. Removed by SAB 47

K. Accounting Series Release 302—Separate Financial Statements Required By Regulation S–X

1. Removed 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 FASB ASC Subtopic 740–30, Income Taxes—Other Considerations or Special Areas, is there considered to be a restriction for purposes of the test?

Interpretive 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?

Interpretive 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

	Net assets
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 undistributed 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% × $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 write-downs, 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% × 45% × $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 FASB ASC subparagraph 323–10–50–3(c) (Investments—Equity Method and Joint Ventures Topic), 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 FASB ASC Subtopic 450–20, Contingencies—Loss Contingencies, and FASB ASC Subtopic 310–10, Receivables—Overall.[6] 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.[7] FASB ASC Subtopic 310–10 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 FASB ASC Subtopic 450–20.

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.[8]

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[6] [Original footnote removed by SAB 114.]

[7] FASB ASC paragraph 450–20–25–2.

[8] For purposes of this interpretation, a loan is defined (consistent with the FASB ASC Master Glossary) 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

Continued

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 methodology [9] 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, Depository and Lending Institutions with Conforming Changes as of June 1, 2009 (Audit Guide), while 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.[10] A registrant's loan loss allowance methodology generally should: [11]

- 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 FASB ASC Subtopic 310–10 and segment the remainder of the portfolio into groups of loans with similar risk characteristics for evaluation and analysis under FASB ASC Subtopic 450–20;
- 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.[12] 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.[13]

A systematic methodology that is properly designed and implemented should result in a registrant's best estimate of its allowance for loan losses.[14] 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.[15]

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.[16]

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receivable or notes receivable with terms less than one year or debt securities subject to the provisions of FASB ASC Topic 320, Investments—Debt and Equity Securities.

[9] 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."

[10] *See* paragraph 9.05 of the Audit Guide.

[11] *Ibid.*

[12] 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."

[13] 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 accounting information included in the financial statements. [Footnote omitted.] Examples of items that may have such an impact are the following:

1. Selection of new or changes to accounting policies
2. Estimates, judgments, and uncertainties
3. Unusual transactions

Accounting policies relating to significant financial statement items, including the timing or transactions and the period in which they are recorded."

[14] Registrants should also refer to FASB ASC Section 450–20–30, Contingencies—Loss Contingencies—Initial Measurement, 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.

[15] Registrants should refer to the guidance on materiality in SAB Topic 1.M.

[16] FRR 28 states: "The specific rationale upon which the [loan loss allowance and provision] amount actually reported is based—*i.e.,* the bridge

The staff normally would expect to find that registrants maintain written supporting documentation for the following decisions, strategies, and processes:[17]

- 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 allowance to be reported in the financial statements;[18]
- 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;[19]
- 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);[20] and
- The system of internal controls used to ensure that the loan loss allowance process is maintained in accordance with GAAP.[21]

The staff normally would expect an internal control system[22] for the loan loss allowance estimation process to:

- Include measures to provide assurance regarding the reliability[23] and integrity of information and compliance with laws, regulations, and internal policies and procedures;[24]
- Reasonably assure that the registrant's financial statements are prepared in accordance with GAAP; and
- Include a well-defined loan review process.[25]

A well-defined loan review process[26] 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;[27]
- 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;[28] 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).[29]

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

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."

[17] Paragraph 9.64 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"); and 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").

[18] Paragraph 9.64 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."

[19] Paragraph 9.56 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.

[20] *Ibid.* As indicated in paragraph 9.56, "[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."

[21] *See also* paragraph 9.64 in the Audit Guide which provides information about specific aspects of effective internal control related to the allowance for loan losses.

[22] *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.

[23] Concepts Statement 2, *Qualitative Characteristics of Accounting Information,* provides guidance on "reliability" as a primary quality of accounting information.

[24] Section 13(b)(2)–(7) of the Exchange Act.

[25] As indicated in paragraph 9.05, item a, in the Audit Guide, a loan loss allowance methodology should "include a detailed and regular analysis of the loan portfolio." Paragraphs 9.06 to 9.13 provide additional information on how creditors traditionally identify and review loans on an individual basis and review or analyze loans on a group or pool basis.

[26] *Ibid.* Additionally, paragraph 9.64 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 competent 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."

[27] *Ibid.*

[28] *Ibid.*

[29] *Ibid.*

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 procedures would describe the methodology:

- For segmenting the portfolio:
  - ○ How the segmentation process is performed (*i.e.,* by loan type, industry, risk rates, *etc.*); [30]
  - ○ 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 FASB ASC Subtopic 310–10: [31]
  - ○ 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 FASB Subtopic 310–10, but not considered to be individually impaired, should be grouped with other loans that share common characteristics for impairment evaluation under FASB ASC Subtopic 450–20.[32]
- For determining and measuring impairment under FASB ASC Subtopic 450–20: [33]
  - ○ 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, and political factors) that may affect loss rates or other loss measurements.

3. Applying a Systematic Methodology—Measuring and Documenting Loan Losses Under FASB ASC Subtopic 310–10

a. Measuring and Documenting Loan Losses Under FASB ASC Subtopic 310–10—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 FASB ASC Subtopic 310–10.

Upon review of the large balance loans, Registrant B determines that certain of the loans are impaired as defined by FASB ASC Subtopic 310–10.[34]

Question: For the commercial loans reviewed under FASB ASC Subtopic 310–10 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 FASB ASC Subtopic 310–10?

Interpretive Response: For those loans that are reviewed individually under FASB ASC Subtopic 310–10 and considered individually impaired, Registrant B must use one of the methods for measuring impairment that is specified by FASB ASC Subtopic 310–10 (that is, the present value of expected future cash flows, the loan's observable market price, or the fair value of collateral).[35] Accordingly, in the circumstances described above, for the loans considered individually impaired under FASB ASC Subtopic 310–10, it would not be appropriate for Registrant B to choose a measurement method not prescribed by FASB ASC Subtopic 310–10. 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 evidence [36] written documentation to support its measurement of loan impairment under FASB ASC Subtopic 310–10.[37] 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 factors [38] 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.[39] 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.

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[30] Paragraph 9.07 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. Loans with similar risk characteristics, such as risk classification, past-due status, and type of loan should be grouped together." Paragraph 9.08 provides additional guidance on classifying individual loans and paragraph 9.13 indicates considerations for groups or pools of loans.

[31] *See* FASB ASC paragraphs 310–10–35–16 through 310–10–35–19 on recognition of impairment and FASB ASC paragraphs 310–10–35–20 through 310–10–35–37 on measurement of impairment.

[32] *See* FASB ASC paragraph 310–10–35–36.

[33] *See* FASB ASC paragraph 450–20–25–2 on accrual of loss contingencies and FASB ASC paragraphs 310–10–35–5 through 310–10–35–11 on collectibility of receivables.

[34] FASB ASC paragraph 310–10–35–8 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.

[35] *See* FASB ASC paragraph 310–10–35–22.

[36] 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.

[37] Paragraph 9.74 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 FASB ASC Subtopic 310–10 or FASB ASC Subtopic 450–20. Additionally, as indicated in paragraphs 9.85 to 9.97 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 9.92) or about the collateral securing the loans, if applicable (*see* paragraphs 9.94 and 9.95).

[38] FASB ASC paragraph 310–10–35–27 indicates that environmental factors include existing industry, geographical, economic, and political factors.

[39] *See* paragraphs 9.94 and 9.95 in the Audit Guide for additional information about documentation of loan collateral.

b. Measuring and Documenting Loan Losses Under FASB ASC Subtopic 310–10 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 FASB ASC Subtopic 310–10 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 FASB ASC Subtopic 310–10. 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.[40] 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.[41] 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.[42] This documentation [43] 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 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 FASB ASC Subtopic 310–10—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 FASB ASC Subtopic 450–20

a. Measuring and Documenting Loan Losses Under FASB ASC Subtopic 450–20—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 FASB ASC Subtopic 450–20?

Interpretive Response: For loans evaluated on a group basis under FASB ASC Subtopic 450–20, the staff believes

[40] 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.

[41] 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).

[42] *See* paragraphs 9.94 to 9.95 in the Audit Guide for further information about documentation of loan collateral and associated audit procedures that may be performed by the independent accountant.

[43] As stated in paragraph 9.14 of the Audit Guide, "[t]he approach for determination of the allowance should be well documented."

that a registrant should segment the loan portfolio by identifying risk characteristics that are common to groups of loans.[44] 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.[45]

Based on the segmentation of the loan portfolio, a registrant should estimate the FASB ASC Subtopic 450–20 portion of its loan loss allowance. For those segments that require an allowance for loan losses,[46] 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.[47] 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.[48]

Facts: After identifying certain loans for evaluation under FASB ASC Subtopic 310–10, Registrant E segments its remaining loan portfolio into five pools of loans. For three of the pools, it measures loan impairment under FASB ASC Subtopic 450–20 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 FASB ASC Subtopic 450–20.

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 FASB ASC Subtopic 450–20?

Interpretive Response: Regardless of the method used to determine loan loss measurements under FASB ASC Subtopic 450–20, Registrant E should demonstrate and document that the loss measurement 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.[49]

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.[50] 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.[51]

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.[52]

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: [53]

- 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 evidence [54] (a) to support the amount of the adjustment and (b) to explain why the adjustment is necessary to reflect current

[44] Paragraph 9.07 of the Audit Guide indicates that "loans with similar risk characteristics, such as risk classification, past-due status, and type of loan, should be grouped together."

[45] Segmentation of the loan portfolio is a standard element in a loan loss allowance methodology. As indicated in paragraph 9.05 of the Audit Guide, the loan loss allowance methodology "should be well documented, with clear explanations of the supporting analyses and rationale."

[46] 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.

[47] 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."

[48] *Ibid.* Also, as indicated in paragraph 9.05 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 9.14 of the Audit Guide, "[t]he approach for determination of the allowance should be well documented."

[49] Refer to FASB ASC subparagraph 450–20–25–2(b). Also, as indicated in FASB ASC subparagraph 310–10–35–4(c), "[t]he approach for determination of the allowance shall be well documented and applied consistently from period to period."

[50] Refer to FASB ASC paragraphs 310–10–35–10 through 310–10–35–11.

[51] Registrants should also refer to FASB ASC Subtopic 450–20, 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 9.14 of the Audit Guide notes the use of "a method that results in a range of estimates for the allowance," except for impairment measurement under FASB ASC Subtopic 310–10, which is based on a single best estimate and not a range of estimates. Paragraph 9.14 also states that "[t]he approach for determination of the allowance should be well documented."

[52] 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 9.05 of the Audit Guide, and FASB ASC Subtopic 310–10.

[53] Refer to paragraph 9.13 in the Audit Guide.

[54] AU 326 describes the "sufficient competent evidential matter" that auditors must consider in accordance with GAAS.

information, events, circumstances, and conditions in the loss measurements.

b. Measuring and Documenting Loan Losses Under FASB ASC Subtopic 450–20—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.

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 lends 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? [55]

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.[56] 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, 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.[57]

c. Measuring and Documenting Loan Losses Under FASB ASC Subtopic 450–20—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 FASB ASC Subtopic 310–10. 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 FASB ASC Subtopic 310–10.

Registrant G segments its loan portfolio to estimate loan losses under FASB ASC Subtopic 450–20. 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.[58]

In its determination of its loan loss allowance under FASB ASC Subtopic 450–20, 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).[59] 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 FASB ASC Subtopic 450–20 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 FASB ASC Subtopic 450–20.[60] The staff also normally would

[55] This question and response would also apply to other registrant fact patterns in which the registrant adjusts loss rates for environmental factors.

[56] Paragraph 9.56 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 9.56, "[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."

[57] Paragraph 9.64 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."

[58] These groups of loans do not include any loans that have been individually reviewed for impairment under FASB ASC Section 310–10–35, Receivables—Overall—Subsequent Measurement, and determined to be impaired as defined by FASB ASC Section 310–10–35.

[59] FASB ASC paragraph 310–10–35–36 states that if a creditor concludes that an individual loan specifically identified for evaluation is not impaired under FASB ASC Subtopic 310–10, that loan may be included in the assessment of the allowance for loan losses under FASB ASC Subtopic 450–20, 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.

[60] Paragraph 9.05 in the Audit Guide indicates that an entity's method of estimating credit losses should "include a detailed and regular analysis of

Continued

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.[61] 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.[62] 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 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.[63] Common elements that the staff normally would expect to find documented in loan loss allowance summaries include: [64]

- 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; [65] and
- 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 FASB ASC Subtopic 310–10 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.[66] 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.[67]

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.[68]

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.[69] As illustrated above, there may be instances in which loan loss allowance reviewers identify

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." FASB ASC paragraph 310–10–35–36 provides guidance as to the analysis to be performed when determining whether a loan that is not individually impaired under FASB ASC Subtopic 310–10 should be included in the assessment of the loan loss allowance under FASB ASC Subtopic 450–20.

[61] *Ibid.*

[62] *Ibid.*

[63] 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 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."

[64] *See also* paragraph 9.14 of the Audit Guide.

[65] Subsequent to adjustments, the staff normally would expect that there would be no material differences between the consolidated loss estimate, 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.

[66] Paragraph 9.64 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."

[67] *See* the guidance in paragraph 9.14 of the Audit Guide ("[t]he approach for determination of the allowance 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").

[68] *Ibid.*

[69] *Ibid.*

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.[70] 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.[71]

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,[72] 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 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.[73]

TOPIC 7: REAL ESTATE COMPANIES

A. Removed by SAB 103

B. Removed 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: The staff believes that FASB ASC Topic 840, Leases, requires department stores and other retailers that lease or license store space to account for rental income from leased departments in accordance with FASB ASC Topic 840. 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 [1] 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 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

[70] *Ibid.*

[71] As outlined in paragraph 9.64 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 previously established methods to arrive at the allowance.

[72] *Ibid.*

[73] *See* paragraph 9.64 of the Audit Guide.

[1] The FASB ASC Master Glossary defines a lease as "an agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time."

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)
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. Removed by SAB 103

B. Removed 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. Removed 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 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.[2]

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 FASB ASC Subtopic 980–360, Regulated Operations—Property, Plant, and Equipment, must charge a portion of the costs of the abandoned plant to expense.[3] Also, the utility determines that it is probable that certain costs of a recently completed plant will be disallowed, and charges those costs to

[1] Before considering the guidance in this SAB Topic, registrants are reminded that the arrangement should be evaluated in accordance with the provisions of FASB ASC Topic 810, Consolidation.

[2] Registrants are reminded that the arrangement may contain a guarantee that is within the scope of FASB ASC Topic 460, Guarantees. Further, registrants should consider the guidance of FASB ASC Topic 810, Consolidation. Also, registrants would need to consider whether the arrangement contains a derivative that should be accounted for according to FASB ASC Topic 815, Derivatives and Hedging.

[3] FASB ASC paragraphs 980–360–35–1 through 980–360–35–3 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, FASB ASC paragraph 980–360–35–12 requires that disallowed costs for recently completed plants be charged to expense when the disallowance becomes probable and can be reasonably estimated.

expense as required by FASB ASC Subtopic 980–360.

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 FASB ASC Subtopic 225–20, Income Statement—Extraordinary and Unusual Items, 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.[4]

FASB ASC paragraph 225–20–45–2 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 FASB ASC Subtopic 980–360 should not be presented as extraordinary items.[5]

[4] Additionally, the registrant was reminded that FASB ASC paragraph 225–20–45–16 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.

[5] The staff also notes that FASB ASC paragraphs 980–360–35–1 through 980–360–35–3 and 980–360–35–12, 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.

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. FASB ASC Subtopic 980–340, Regulated Operations—Other Assets and Deferred Costs, 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 FASB ASC paragraph 980–340–25–1 [6] should be presented on the balance sheet as an asset and should not be offset against the liability. Contingent recoveries through rates that do not meet the criteria of FASB ASC paragraph 980–340–25–1 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. FASB ASC Subtopic 450–20, Contingencies—Loss Contingencies, 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.[7] The staff believes that actions of a regulator can affect whether an incurred cost is capitalized or expensed pursuant to FASB ASC Subtopic 980–340, but the regulator's actions cannot affect the timing of the recognition of the liability.

[6] FASB ASC paragraph 980–340–25–16 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.

[7] Registrants also should apply the guidance of FASB ASC Subtopic 410–30, Asset Retirement and Environmental Obligations—Environmental Obligations, in determining the appropriate recognition of environmental remediation costs.

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. Removed 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 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

[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.

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 therefore 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 FASB ASC Subtopic 310–40, Receivables—Troubled Debt Restructurings by Creditors.

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 disclosed, if material, due to their unique features.[2]

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

[2] Registrants also are reminded that if the security received in the exchange constitutes a debt security within the scope of FASB ASC Topic 320, Investments—Debt and Equity Securities, the disclosures required by FASB ASC Topic 320 also would need to be provided.

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.[3]

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 $__ million of Mexican Government Bonds maturing in 2008, with a carrying value of $__ million [if different from face value]. These Mexican Government Bonds had a market value of $__ million on [reporting date]. The principal amount of these bonds is fully secured, at maturity, by $__ 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 $__ 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%.

[3] 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.

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 $__ 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 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 $___ face U.S. Zero Coupon Treasury Securities which mature on the same date and have a current fair value of $___. 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. Removed 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.[4]

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?

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 issued [5] 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 and concluded that registrants should discuss the potential effects of adoption of recently issued accounting standards in registration statements and reports filed with the Commission.[6] 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.[7] MD&A [8] 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

[4] 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.

[5] 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.

[6] FRR 6, Section 2.

[7] 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.

[8] Item 303 of Regulation S–K.

requirements. With respect to financial statement disclosure, GAAS [9] 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 retrospectively adjusted 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.[10, 11] Further, the nature, extent and impact of such assistance needs to be fully discussed in Management's Discussion and Analysis.[12]

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 Reserve Quantities

Facts: Rule 4–10 of Regulation S–X contains definitions of possible reserves, probable reserves, and proved and developed oil and gas reserves to be used in determining quantities of oil and gas reserves to be reported in filings with the Commission.

Question: 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 staff will not object to natural gas reserves and production data calculated at other pressure bases, if such pressure bases are identified in the filing.

2. Estimates of Future Net Revenues

Facts: U.S. GAAP requires the disclosure of the standardized measure of discounted future net cash flows from production of proved oil and gas reserves.

Question: F or purposes of determining reserves and estimated future net revenues, what price should be used for oil and 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 oil and gas which will be produced after a contract expires or has a redetermination is the average price during the 12-month period prior to the ending date of the period covered by the balance sheet, determined as an unweighted arithmetic average of the first-day-of-the-month price for each month within such period for that oil and gas. This average price, which should be based on the first-day-of-the-month market prices, may be increased thereafter only for additional fixed and determinable escalations, as appropriate. A fixed and determinable escalation is one which is specified in amount and is not based on future events such as rates of inflation.

3. Disclosure of Reserve Information

a. Removed by SAB 103
b. Removed by SAB 113
c. Limited Partnership 10–K Reports

Facts: Item 1201(a) of Regulation S–K contains an exemption from the requirements 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 that acquire properties either for drilling and production, or for production of oil, gas, or geothermal steam. * * *"

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

[9] *See* AU 9410.13–18.

[10] The staff has previously expressed its views regarding acceptable methods of compliance with this principle in FASB ASC paragraph 942–10–S99–6 (Financial Services—Depository and Lending Topic).

[11] *See* FASB ASC paragraph 942–10–S99–6 for guidance on the appropriate period in which to record certain types of regulatory assistance.

[12] *See* Section 501.06.c. of the Financial Reporting Codification for further discussion of the MD&A disclosures of the effects of regulatory assistance.

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 in FASB ASC paragraphs 932–235–50–23 through 932–235–50–36 (Extractive Activities—Oil and Gas Topic)?

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 listed in FASB ASC paragraphs 932–235–50–23 through 932–235–50–36 for partnerships which are the subject of a business combination or exchange offer under which various limited partnerships are to be consolidated or combined into a single entity.

d. Removed by SAB 113

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 FASB ASC paragraphs 932–235–50–29 through 932–235–50–36?

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. Removed by SAB 103

B. Removed 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. 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 in part 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: May a subsidiary of the parent use the full cost method if the parent company uses the successful efforts method of accounting for oil and gas producing activities?

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) in Rule 4–10(c)(4)(i) of Regulation S–X provides 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) alternative minimum taxes on tax preference items, and (vi) the impact of statutory (percentage) depletion.

It may often be difficult to allocate a net operating loss (NOL) carryforward between oil and gas assets and other assets. However, to the extent that the NOL is clearly attributable to oil and gas operations and is expected to be realized within the carryforward period, it 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 NOL 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:			
Cost of proved properties being amortized		$396,000	
Lower of cost or estimated fair value of unproved properties to be amortized		49,000	
Cost of properties not being amortized		*55,000*	
Capitalized costs of oil and gas assets		500,000	
Accumulated DD&A		*(100,000)*	
Book basis of oil and gas assets			$400,000
Excess of book basis over tax basis ($270,000) of oil and gas assets		$(130,000)	
NOL carryforward*		*20,000*	
		(110,000)	
Statutory tax rate (percent)		×*46%*	
		(50,600)	
Foreign tax credit carryforward*		1,000	
ITC carryforward*		*2,000*	
Related net deferred income tax liability			*(47,600)*
Net book basis to be recovered			*$352,400*
Other Assumptions:			
Present value of ITC relating to future development costs		$1,500	
Present value of statutory depletion attributable to future deductions		$10,000	
Estimated preference (minimum) tax on percentage depletion in excess of cost depletion		$500	
Present value of future net revenue from proved oil and gas reserves		$272,000	
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*	
Total ceiling limitation before tax effects			$376,000
Tax Effects:			
Total ceiling limitation before tax effects		$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 at statutory rate		(34,960)	
ITC (future development costs and carryforward)		3,500	
Foreign tax credit carryforward		1,000	
Estimated preference tax		*(500)*	
Net tax effects			*(30,960)*
Cost Center Ceiling			$345,040
Less: Net book basis to be recovered			*352,400*
REQUIRED WRITE-OFF, net of tax**			*$(7,360)*

* All carryforward amounts in this example represent amounts which are available for tax purposes and which relate 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.

CALCULATION OF GROSS PRE-TAX WRITE-OFF:			
Required write-off, net of tax			$(7,360)
Divided by (100% minus the statutory rate of 46%)			*54%*
Gross pre-tax write-off			$*(13,630)*

Related Journal Entries	**DR**	**CR**	
Full cost ceiling impairment	$13,630		
Oil and gas assets		$13,630	
Deferred income tax liability	$6,270		
Deferred income tax benefit		$6,270	

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 FASB ASC Subtopic 932–835, Extractive Activities—Oil and Gas—Interest, and FASB ASC Subtopic 835–20, Interest—Capitalization of Interest, 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:

	Total	Purchased reserves	Other proved properties	Unproved properties
(Amounts in thousands)				
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	

Comparison of capitalized costs with limitation on capitalized costs at December 31, 20x1:		Including purchased reserves	Excluding purchased reserves	
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 was 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 prices, as defined in Rule 4–10(c)(8) of Regulation S–X, for oil and natural gas. However, prior to the balance sheet date, the company entered 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 or lower than the estimated future cash flows indicated by use of the average price during the 12-month period prior to the balance sheet date, determined as an unweighted arithmetic average of the first-day-of-the-month price for each month within such period. These arrangements qualify as cash flow hedges under the provisions of FASB ASC Topic 815, Derivatives and Hedging, 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 or lower prices to be received after taking into account the hedging arrangements ("hedge-adjusted prices") in calculating the estimated cash flows from 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 a hedging instrument in a cash flow hedge and are accounted for as such pursuant to FASB ASC Topic 815 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. However, the staff believes that FASB ASC Topic 815 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 more or less than the average price during the 12-month period prior to the balance sheet date, determined as an unweighted arithmetic average of the first-day-of-the-month price for each month within such period. 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 FASB ASC Section 275–10–50, Risks and Uncertainties—Overall—Disclosure. FASB ASC paragraph 275–10–50–9 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 Financial Reporting Release No. 60 (Release Nos. 33–8040; 34–45149), Cautionary Advice Regarding Disclosure about Critical Accounting Policies (December 12, 2001), and Financial Reporting Release No. 72 (Release Nos. 33–8350; 34–48960), Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations (December 29, 2003). Through these releases, 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 reporting 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 the 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 auditor's report on the company's financial statements, assume that additional reserves are proved up (excluding the effect of increased oil and gas prices subsequent to year-end) on properties owned at year-end. The present value of future net revenues from the additional reserves 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. Is it necessary to record a write-down?

Interpretive Response: No. In this case, the proving up of additional reserves on properties owned at year-end 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.

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. However, such quantities 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.

4. Interaction of FASB ASC Subtopic 410–20, Asset Retirement and Environmental Obligations—Asset Retirement Obligations, and the Full Cost Rules

a. Impact of FASB ASC Subtopic 410–20 on the Full Cost Ceiling Test

Facts: A company following the full cost method of accounting under Rule 4–10(c) of Regulation S–X must periodically calculate a limitation on capitalized costs, *i.e.,* the full cost ceiling. Under FASB ASC Subtopic 410–20, a company must recognize a liability for an asset retirement obligation (ARO) at fair value in the period in which the obligation is incurred, if a reasonable estimate of fair value can be made. The company also must initially capitalize the associated asset retirement costs by increasing long-lived oil and gas assets by the same amount as the liability. Any asset retirement costs capitalized pursuant to FASB ASC Subtopic 410–20 are subject to the full cost ceiling limitation under Rule 4–10(c)(4) of Regulation S–X. If a company were to calculate the full cost ceiling by reducing expected future net revenues by the cash flows required to settle the ARO, then the effect would be to "double-count" such costs in the ceiling test. The assets that must be recovered would be increased while the future net revenues available to recover the assets continue to be reduced by the amount of the ARO settlement cash flows.

Question: How should a company compute the full cost ceiling to avoid double-counting the expected future cash outflows associated with asset retirement costs?

Interpretive Response: The future cash outflows associated with settling AROs that have been accrued on the balance sheet should be excluded from the computation of the present value of estimated future net revenues for purposes of the full cost ceiling calculation.[1,2]

b. Impact of FASB ASC Subtopic 410–20 on the Calculation of Depreciation, Depletion, and Amortization

Facts: Regarding the base for depreciation, depletion, and amortization (DD&A) of proved reserves, Rule 4–10(c)(3)(i) of Regulation S–X states that "[c]osts to be amortized shall include (A) all capitalized costs, less accumulated amortization, other than the cost of properties described in paragraph (ii) below; [3] (B) the estimated future expenditures (based on current costs) to be incurred in developing proved reserves; and (C) estimated dismantlement and abandonment costs, net of estimated salvage values." FASB ASC Subtopic 410–20 requires that upon initial recognition of an ARO, the associated asset retirement costs be included in the capitalized costs of the company. Therefore, the estimated dismantlement and abandonment costs described in (C) above may be included in the capitalized costs described in (A) above, at least to the extent that an ARO has been incurred as a result of acquisition, exploration and development activities to date. Future development activities on proved reserves may result in additional asset retirement obligations when such activities are performed and the associated asset retirement costs will be capitalized at that time.

Question: Should the costs to be amortized under Rule 4–10(c)(3) of Regulation S–X include an amount for estimated dismantlement and abandonment costs, net of estimated salvage values, that are expected to result from future development activities?

Interpretive Response: Yes. Companies should estimate the amount of dismantlement and abandonment costs that will be incurred as a result of future development activities on proved reserves and include those amounts in the costs to be amortized.

c. Removed by SAB 113

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,

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[1] If an obligation for expected asset retirement costs has not been accrued under FASB ASC Subtopic 410–20 for certain asset retirement costs required to be included in the full cost ceiling calculation under Rule 4–10(c)(4) of Regulation S–X, such costs should continue to be included in the full cost ceiling calculation.

[2] This approach is consistent with the guidance in FASB ASC Subtopic 410–20 on testing for impairment under FASB ASC Section 360–10–35, Property, Plant, and Equipment—Overall—Subsequent Measurement. Under that guidance, the asset tested should include capitalized asset retirement costs. The estimated cash flows related to the associated ARO that has been recognized in the financial statements are to be excluded from both the undiscounted cash flows used to test for recoverability and the discounted cash flows used to measure the asset's fair value.

[3] The reference to "cost of properties described in paragraph (ii) below" relates to the costs of investments in unproved properties and major development projects, as defined.

[4] Rule 4–10(c)(8) of Regulation S–X defines current price as the average price during the 12-month period prior to the ending date of the period covered by the report, determined as an unweighted

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." [4]

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 sales 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. Removed by SAB 113

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.[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, *Recognition and Measurement in Financial Statements of Business Enterprises,* 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]
- 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]

Some revenue arrangements contain multiple revenue-generating activities. The staff believes that the determination of the units of accounting within an arrangement should be made prior to the application of the guidance in this SAB Topic by reference to the applicable accounting literature.[7]

[4] Rule 4–10(c)(8) of Regulation S–X defines current price as the average price during the 12-month period prior to the ending date of the period covered by the report, determined as an unweighted arithmetic average of the first-day-of-the-month price for each month within such period, unless prices are defined by contractual arrangements, excluding escalations based upon future conditions.

[1] The February 1999 AICPA publication "Audit Issues in Revenue Recognition" provides an overview of the authoritative accounting literature and auditing procedures for revenue recognition and identifies indicators of improper revenue recognition.

[2] Concepts Statement 5, paragraphs 83–84; FASB ASC paragraph 605–10–25–1 (Revenue Recognition Topic); FASB ASC paragraph 605–10–25–3; FASB ASC paragraph 605–10–25–5. 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 2, 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* FASB ASC paragraph 985–605–25–3 (Software Topic). The use of the term "arrangement" in this SAB Topic 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); FASB ASC subparagraph 605–15–25–1(a); FASB ASC paragraph 985–605–25–3. The FASB ASC Master Glossary 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." FASB ASC paragraphs 985–605–25–30 through 985–605–25–40 discuss how to apply the fixed or determinable fee criterion in software transactions. The staff believes that the guidance in FASB ASC paragraphs 985–605–25–30 through 985–605–25–31 and 985–605–25–36 through 985–605–25–40 is appropriate for other sales transactions where authoritative guidance does not otherwise exist. The staff notes that FASB ASC paragraphs 985–605–25–33 through 985–605–25–35 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] FASB ASC paragraph 605–10–25–3 through 605–10–25–5. *See also* Concepts Statement 5, paragraph 84(g) and FASB ASC paragraph 985–605–25–3.

[7] *See* FASB ASC paragraph 605–25–15–2 through 605–25–15–3 for additional discussion.

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 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.[8] 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,[9]

(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,[10]

(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,[11]

(d) The buyer acquiring the product for resale does not have economic substance apart from that provided by the seller,[12] or

(e) The seller has significant obligations for future performance to directly bring about resale of the product by the buyer.[13]

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,[14] and the amounts to be paid by the seller will be adjusted, as necessary, to cover substantially all

[8] AU Section 560.05.

[9] FASB ASC subparagraph 605–15–25–1(b).

[10] FASB ASC subparagraph 605–15–25–1(b). 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.

[11] FASB ASC subparagraph 605–15–25–1(c).

[12] FASB ASC subparagraph 605–15–25–1(d).

[13] FASB ASC subparagraph 605–15–25–1(e).

[14] FASB ASC subparagraph 470–40–15–2(a) (Debt Topic). This paragraph 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.

fluctuations in costs incurred by the buyer in purchasing and holding the product (including interest).[15] 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 FASB ASC paragraphs 840–10–55–12 through 840–10–55–21 (Leases Topic) and does not qualify for sales-type lease accounting.

4. The product is delivered for demonstration purposes.[16]

This list is not meant to be a checklist of all characteristics of a consignment or 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 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.

Question 3

Facts: The laws of some countries do not provide for a seller's retention of a security interest in goods in the same manner as established in the U.S. Uniform Commercial Code (UCC). In these countries, it is common for a seller to retain a form of title to goods delivered to customers until the customer makes payment so that the seller can recover the goods in the event of customer default on payment.

Question: Is it acceptable to recognize revenue in these transactions before payment is made and title has transferred?

Interpretive Response: Presuming all other revenue recognition criteria have been met, the staff would not object to revenue recognition at delivery if the only rights that a seller retains with the title are those enabling recovery of the goods in the event of customer default on payment. This limited form of ownership may exist in some foreign jurisdictions where, despite technically holding title, the seller is not entitled to direct the disposition of the goods, cannot rescind the transaction, cannot prohibit its customer from moving, selling, or otherwise using the goods in the ordinary course of business, and has no other rights that rest with a titleholder of property that is subject to a lien under the U.S. UCC. On the other hand, if retaining title results in the seller retaining rights normally held by an owner of goods, the situation is not sufficiently different from a delivery of goods on consignment. In this particular case, revenue should not be recognized until payment is received. Registrants and their auditors may wish to consult legal counsel knowledgeable of the local law and customs outside the U.S. to determine the seller's rights.

3. Delivery and Performance

a. Bill and Hold Arrangements

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.[17] 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.[18] 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 that 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:[19]

1. The date by which the seller expects payment, and whether the seller has modified its normal billing and credit terms for this buyer;[20]

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[15] FASB ASC subparagraph 470–40–15–2(b).

[16] *See* FASB ASC paragraphs 985–605–25–28 through 985–605–25–29.

[17] *See* In the Matter of Stewart Parness, AAER 108 (August 5, 1986); SEC v. Bollinger Industries, Inc., *et al.,* LR 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). *See also* Concepts Statement 5, paragraph 84(a) and FASB ASC paragraph 985–605–25–25.

[18] Such requests typically should be set forth in writing by the buyer.

[19] *See* Note 17, *supra.*

[20] Such individuals should consider whether FASB ASC Subtopic 835–30, Interest—Imputation of Interest, pertaining to the need for discounting the related receivable, is applicable. FASB ASC subparagraph 835–30–15–3(a) indicates that the requirements of that Subtopic 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).

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.[21]

b. Customer Acceptance

After delivery of a product or performance of a service, if uncertainty exists about customer acceptance, revenue should not be recognized until acceptance occurs.[22] 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.

Question 1

Question: Do circumstances exist in which formal customer sign-off (that a contractual customer acceptance provision is met) is unnecessary to meet the requirements to recognize revenue?

Interpretive Response: Yes. Formal customer sign-off is not always necessary to recognize revenue provided that the seller objectively demonstrates that the criteria specified in the acceptance provisions are satisfied. Customer acceptance provisions generally allow the customer to cancel the arrangement when a seller delivers a product that the customer has not yet agreed to purchase or delivers a product that does not meet the specifications of the customer's order. In those cases, revenue should not be recognized because a sale has not occurred. In applying this concept, the staff observes that customer acceptance provisions normally take one of four general forms. Those forms, and how the staff generally assesses whether customer acceptance provisions should result in revenue deferral, are described below:

(a) *Acceptance provisions in arrangements that purport to be for trial or evaluation purposes.*[23] In these arrangements, the seller delivers a product to a customer, and the customer agrees to receive the product, solely to give the customer the ability to evaluate the delivered product prior to acceptance. The customer does not agree to purchase the delivered product until it accepts the product. In some cases, the acceptance provisions lapse by the passage of time without the customer rejecting the delivered product, and in other cases affirmative acceptance from the customer is necessary to trigger a sales transaction. Frequently, the title to the product does not transfer and payment terms are not established prior to customer acceptance. These arrangements are, in substance, consignment arrangements until the customer accepts the product as set forth in the contract with the seller. Accordingly, in arrangements where products are delivered for trial or evaluation purposes, revenue should not be recognized until the earlier of when acceptance occurs or the acceptance provisions lapse.

In contrast, other arrangements do not purport to be for trial or evaluation purposes. In these instances, the seller delivers a specified product pursuant to a customer's order, establishes payment terms, and transfers title to the delivered product to the customer. However, customer acceptance provisions may be included in the arrangement to give the purchaser the ability to ensure the delivered product meets the criteria set forth in its order. The staff evaluates these provisions as follows:

(b) *Acceptance provisions that grant a right of return or exchange on the basis of subjective matters.* An example of such a provision is one that allows the customer to return a product if the customer is dissatisfied with the product.[24] The staff believes these provisions are not different from general rights of return and should be accounted for in accordance with FASB ASC Subtopic 605–15, Revenue Recognition—Products. This Subtopic requires that the amount of future returns must be reasonably estimable in order for revenue to be recognized prior to the expiration of return rights.[25] That estimate may not be made in the absence of a large volume of homogeneous transactions or if customer acceptance is likely to depend on conditions for which sufficient historical experience is absent.[26] Satisfaction of these requirements may vary from product-to-product, location-to-location, customer-to-customer, and vendor-to-vendor.

(c) *Acceptance provisions based on seller-specified objective criteria.* An example of such a provision is one that gives the customer a right of return or replacement if the delivered product is defective or fails to meet the vendor's published specifications for the product.[27] Such rights are generally identical to those granted to all others within the same class of customer and for which satisfaction can be generally assured without consideration of conditions specific to the customer. Provided the seller has previously demonstrated that the product meets the specified criteria, the staff believes that these provisions are not different from general or specific warranties and should be accounted for as warranties in accordance with FASB ASC Subtopic 450–20, Contingencies—Loss Contingencies. In this case, the cost of potentially defective goods must be reliably estimable based on a demonstrated history of substantially similar transactions.[28] However, if the seller has not previously demonstrated that the delivered product meets the seller's specifications, the staff believes that revenue should be deferred until the specifications have been objectively achieved.

[21] FASB ASC paragraph 985–605–25–25.

[22] FASB ASC paragraph 985–605–25–21. 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.

[23] *See,* for example, FASB ASC paragraphs 985–605–25–28 through 985–605–25–29.

[24] FASB ASC paragraph 605–15–05–3.

[25] FASB ASC subparagraph 605–15–25–1(f).

[26] FASB ASC subparagraphs 605–15–25–3(c) and 605–15–25–3(d).

[27] FASB ASC paragraph 460–10–25–5 (Guarantees Topic) and FASB ASC subparagraph 605–15–15–3(c).

[28] FASB ASC paragraph 460–10–25–6.

(d) *Acceptance provisions based on customer-specified objective criteria.* These provisions are referred to in this document as “customer-specific acceptance provisions” against which substantial completion and contract fulfillment must be evaluated. While formal customer sign-off provides the best evidence that these acceptance criteria have been met, revenue recognition also would be appropriate, presuming all other revenue recognition criteria have been met, if the seller reliably demonstrates that the delivered products or services meet all of the specified criteria prior to customer acceptance. For example, if a seller reliably demonstrates that a delivered product meets the customer-specified objective criteria set forth in the arrangement, the delivery criterion would generally be satisfied when title and the risks and rewards of ownership transfers unless product performance may reasonably be different under the customer's testing conditions specified by the acceptance provisions. Further, the seller should consider whether it would be successful in enforcing a claim for payment even in the absence of formal sign-off. Whether the vendor has fulfilled the terms of the contract before customer acceptance is a matter of contract law, and depending on the facts and circumstances, an opinion of counsel may be necessary to reach a conclusion.

Question 2

Facts: Consider an arrangement that calls for the transfer of title to equipment upon delivery to a customer's site. However, customer-specific acceptance provisions permit the customer to return the equipment unless the equipment satisfies certain performance tests. The arrangement calls for the vendor to perform the installation. Assume the equipment and the installation are separate units of accounting under FASB ASC Subtopic 605–25, Revenue Recognition—Multiple-Element Arrangements.[29]

Question: Must revenue allocated to the equipment always be deferred until installation and on-site testing are successfully completed?

Interpretive Response: No. The staff would not object to revenue recognition for the equipment upon delivery (presuming all other revenue recognition criteria have been met for the equipment) if the seller demonstrates that, at the time of delivery, the equipment already meets all of the criteria and specifications in the customer-specific acceptance provisions. This may be demonstrated if conditions under which the customer intends to operate the equipment are replicated in pre-shipment testing, unless the performance of the equipment, once installed and operated at the customer's facility, may reasonably be different from that tested prior to shipment.

Determining whether the delivered equipment meets all of a product's criteria and specifications is a matter of judgment that must be evaluated in light of the facts and circumstances of a particular transaction. Consultation with knowledgeable project managers or engineers may be necessary in such circumstances.

For example, if the customer acceptance provisions were based on meeting certain size and weight characteristics, it should be possible to determine whether those criteria have been met before shipment. Historical experience with the same specifications and functionality of a particular machine that demonstrates that the equipment meets the customer's specifications also may provide sufficient evidence that the currently shipped equipment satisfies the customer-specific acceptance provisions.

If an arrangement includes customer acceptance criteria or specifications that cannot be effectively tested before delivery or installation at the customer's site, the staff believes that revenue recognition should be deferred until it can be demonstrated that the criteria are met. This situation usually will exist when equipment performance can vary based on how the equipment works in combination with the customer's other equipment, software, or environmental conditions. In these situations, testing to determine whether the criteria are met cannot be reasonably performed until the products are installed or integrated at the customer's facility.

Although the following questions provide several examples illustrating how the staff evaluates customer acceptance, the determination of when customer-specific acceptance provisions of an arrangement are met in the absence of the customer's formal notification of acceptance depends on the weight of the evidence in the particular circumstances. Different conclusions could be reached in similar circumstances that vary only with respect to a single variable, such as complexity of the equipment, nature of the interface with the customer's environment, extent of the seller's experience with the same type of transactions, or a particular clause in the agreement. The staff believes management and auditors are uniquely positioned to evaluate the facts and arrive at a reasoned conclusion. The staff will not object to a determination that is well reasoned on the basis of this guidance.

Question 3

Facts: Company E is an equipment manufacturer whose main product is generally sold in a standard model. The contracts for sale of that model provide for customer acceptance to occur after the equipment is received and tested by the customer. The acceptance provisions state that if the equipment does not perform to Company E's published specifications, the customer may return the equipment for a full refund or a replacement unit, or may require Company E to repair the equipment so that it performs up to published specifications. Customer acceptance is indicated by either a formal sign-off by the customer or by the passage of 90 days without a claim under the acceptance provisions. Title to the equipment passes upon delivery to the customer. Company E does not perform any installation or other services on the equipment it sells and tests each piece of equipment against its specifications before shipment. Payment is due under Company E's normal payment terms for that product 30 days after customer acceptance.

Company E receives an order from a new customer for a standard model of its main product. Based on the customer's intended use of the product, location and other factors, there is no reason that the equipment would operate differently in the customer's environment than it does in Company E's facility.

Question: Assuming all other revenue recognition criteria are met (other than the issue raised with respect to the acceptance provision), when should Company E recognize revenue from the sale of this piece of equipment?

Interpretive Response: While the staff presumes that customer acceptance provisions are substantive provisions that generally result in revenue deferral, that presumption can be overcome as discussed above. Although the contract includes a customer acceptance clause, acceptance is based on meeting Company E's published specifications for a standard model. Company E demonstrates that the equipment shipped meets the specifications before shipment, and the equipment is expected to operate the same in the customer's environment as it does in

[29] This fact is provided as an assumption to facilitate an analysis of revenue recognition in this fact pattern. No interpretation of FASB ASC Subtopic 605–25 is intended.

Company E's. In this situation, Company E should evaluate the customer acceptance provision as a warranty under FASB ASC Subtopic 450–20. If Company E can reasonably and reliably estimate the amount of warranty obligations, the staff believes that it should recognize revenue upon delivery of the equipment, with an appropriate liability for probable warranty obligations.

Question 4

Facts: Assume the same facts about Company E's equipment, contract terms and customary practices as in Question 3 above. Company E enters into an arrangement with a new customer to deliver a version of its standard product modified as necessary to fit into a space of specific dimensions while still meeting all of the published vendor specifications with regard to performance. In addition to the customer acceptance provisions relating to the standard performance specifications, the customer may reject the equipment if it does not conform to the specified dimensions. Company E creates a testing chamber of the exact same dimensions as specified by the customer and makes simple design changes to the product so that it fits into the testing chamber. The equipment still meets all of the standard performance specifications.

Question: Assuming all other revenue recognition criteria are met (other than the issue raised with respect to the acceptance provision), when should Company E recognize revenue from the sale of this piece of equipment?

Interpretive Response: Although the contract includes a customer acceptance clause that is based, in part, on a customer specific criterion, Company E demonstrates that the equipment shipped meets that objective criterion, as well as the published specifications, before shipment. The staff believes that the customer acceptance provisions related to the standard performance specifications should be evaluated as a warranty under FASB ASC Subtopic 450–20. If Company E can reasonably and reliably estimate the amount of warranty obligations, it should recognize revenue upon delivery of the equipment, with an appropriate liability for probable warranty obligations.

Question 5

Facts: Assume the same facts about Company E's equipment, contract terms and customary practices as in Question 3 above. Company E enters into an arrangement with a new customer to deliver a version of its standard product modified as necessary to be integrated into the customer's new assembly line while still meeting all of the standard published vendor specifications with regard to performance. The customer may reject the equipment if it fails to meet the standard published performance specifications or cannot be satisfactorily integrated into the new line. Company E has never modified its equipment to work on an integrated basis in the type of assembly line the customer has proposed. In response to the request, Company E designs a version of its standard equipment that is modified as believed necessary to operate in the new assembly line. The modified equipment still meets all of the standard published performance specifications, and Company E believes the equipment will meet the requested specifications when integrated into the new assembly line. However, Company E is unable to replicate the new assembly line conditions in its testing.

Question: Assuming all other revenue recognition criteria are met (other than the issue raised with respect to the acceptance provision), when should Company E recognize revenue from the sale of this piece of equipment?

Interpretive Response: This contract includes a customer acceptance clause that is based, in part, on a customer specific criterion, and Company E cannot demonstrate that the equipment shipped meets that criterion before shipment. Accordingly, the staff believes that the contractual customer acceptance provision has not been met at shipment. Therefore, the staff believes that Company E should wait until the product is successfully integrated at its customer's location and meets the customer-specific criteria before recognizing revenue. While this is best evidenced by formal customer acceptance, other objective evidence that the equipment has met the customer-specific criteria may also exist (*e.g.,* confirmation from the customer that the specifications were met).

c. Inconsequential or Perfunctory Performance Obligations

Question 1

Question: Does the failure to complete all activities related to a unit of accounting preclude recognition of revenue for that unit of accounting?

Interpretive Response: No. Assuming all other recognition criteria are met, revenue for the unit of accounting may be recognized in its entirety if the seller's remaining obligation is inconsequential or perfunctory.

A seller should substantially complete or fulfill the terms specified in the arrangement related to the unit of accounting at issue in order for delivery or performance to have occurred.[30] 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 terms specified in the arrangement related to the unit of accounting at issue, all related costs of performance or delivery should be accrued.

Question 2

Question: What factors should be considered in the evaluation of whether a remaining obligation related to a unit of accounting is inconsequential or perfunctory?

Interpretive Response: A remaining performance obligation is not inconsequential or perfunctory if it is essential to the functionality of the delivered products or services. In addition, remaining activities are not inconsequential or perfunctory if failure to complete the activities would result in the customer receiving a full or partial refund or rejecting (or a right to a refund or to reject) the products delivered or services performed to date. The terms of the sales contract regarding both the right to a full or partial refund and the right of return or rejection should be considered when evaluating whether a portion of the purchase price would be refundable. If the company has a historical pattern of granting such rights, that historical pattern should also be considered even if the current contract expressly precludes such rights. Further, other factors should be considered in assessing whether remaining obligations are inconsequential or perfunctory. For example, the staff also considers the following factors, which are not all-inclusive, to be indicators that a remaining performance obligation is substantive rather than inconsequential or perfunctory:

- The seller does not have a demonstrated history of completing the remaining tasks in a timely manner and reliably estimating their costs.

[30] 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 the benefits represented by the revenues."

• The cost or time to perform the remaining obligations for similar contracts historically has varied significantly from one instance to another.

• The skills or equipment required to complete the remaining activity are specialized or are not readily available in the marketplace.

• The cost of completing the obligation, or the fair value of that obligation, is more than insignificant in relation to such items as the contract fee, gross profit, and operating income allocable to the unit of accounting.

• The period before the remaining obligation will be extinguished is lengthy. Registrants should consider whether reasonably possible variations in the period to complete performance affect the certainty that the remaining obligations will be completed successfully and on budget.

• The timing of payment of a portion of the sales price is coincident with completing performance of the remaining activity.

Registrants' determinations of whether remaining obligations are inconsequential or perfunctory should be consistently applied.

Question 3

Facts: Consider a unit of accounting that includes both equipment and installation because the two deliverables do not meet the separation criteria under FASB ASC Subtopic 605–25. This may be because the equipment does not have value to the customer on a standalone basis, there is no objective and reliable evidence of fair value for the installation or there is a general right of return when the installation is not considered probable and in control of the vendor.

Question: In this situation, must all revenue be deferred until installation is performed?

Interpretive Response: Yes, if installation is essential to the functionality of the equipment.[31] Examples of indicators that installation is essential to the functionality of equipment include:

• The installation involves significant changes to the features or capabilities of the equipment or building complex interfaces or connections;

• The installation services are unavailable from other vendors.[32]

Conversely, examples of indicators that installation is not essential to the functionality of the equipment include:

• The equipment is a standard product;

• Installation does not significantly alter the equipment's capabilities;

• Other companies are available to perform the installation.[33]

If it is determined that the undelivered service is not essential to the functionality of the delivered product but a portion of the contract fee is not payable until the undelivered service is delivered, the staff would not consider that obligation to be inconsequential or perfunctory. Generally, the portion of the contract price that is withheld or refundable should be deferred until the outstanding service is delivered because that portion would not be realized or realizable.[34]

d. License Fee Revenue

Facts: Assume that intellectual property is physically delivered and payment is received on December 20, upon the registrant's consummation of an agreement granting its customer a license to use the intellectual property for a term beginning on the following January 1.

Question: Should the license fee be recognized in the period ending December 31?

Interpretive Response: No. 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.[35] 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 consistent with the nature of the transaction and the earnings process.

e. Layaway Sales Arrangements

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 "the customer must have made a fixed commitment to purchase the goods."

f. Nonrefundable Up-front Fees

Question 1

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:

[31] FASB ASC paragraph 985–605–25–12.

[32] *See* FASB ASC paragraphs 985–605–25–81 through 985–605–25–85 for analogous guidance.

[33] *Ibid.*

[34] Concepts Statement 5, paragraph 83(a) and FASB ASC subparagraph 605–15–25–1(b).

[35] FASB ASC paragraph 926–605–25–1 (Entertainment—Films Topic).

• 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.

• A registrant charges users a fee for non-exclusive access to its Web site that contains proprietary databases. The fee allows access to the Web site for a one-year period. After the customer is provided with an identification number and trained in the use of the database, there are no incremental costs that will be incurred in serving this customer.

• A registrant charges a fee to users for advertising a product for sale or auction on certain pages of its Web site. The company agrees to maintain the listing for a period of time. The cost of maintaining the advertisement on the Web site for the stated period is minimal.

• A registrant charges a fee for hosting another company's Web site for one year. The arrangement does not involve exclusive use of any of the hosting company's servers or other equipment. Almost all of the projected costs to be incurred will be incurred in the initial loading of information on the host company's Internet server and setting up appropriate links and network connections.

Question: Assuming these arrangements qualify as single units of accounting under FASB ASC Subtopic 605–25,[36] 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,[37] the deferral of revenue is appropriate.

In the situations described above, the staff does not view the activities completed by the registrants (*i.e.,* selling the membership, signing the contract, enrolling the customer, activating telecommunications services or providing initial set-up services) as discrete earnings events.[38] 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.

While the incurrence of nominal up-front costs helps make it clear that there is not a separate earnings event in the telecommunications example above, incurrence of substantive costs, such as in the Web hosting example above, does not necessarily indicate that there is a separate earnings event. Whether there is a separate earnings event should be evaluated on a case-by-case basis. Some have questioned whether revenue may be recognized in these transactions to the extent of the incremental direct costs incurred in the activation. Because there is no separable deliverable or earnings event, the staff would generally object to that approach, except where it is provided for in the authoritative literature (*e.g.,* FASB ASC Subtopic 922–605, Entertainment—Cable Television—Revenue Recognition).

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 performance[39] and generally should be deferred and recognized systematically over the periods that the fees are earned.[40]

Some propose that revenue should be recognized when the initial set-up is completed in cases where the on-going obligation involves minimal or no cost or effort and should, therefore, be considered perfunctory or inconsequential. However, the staff believes that the substance of each of these transactions indicates that the purchaser is paying for a service that is delivered over time. Therefore, revenue recognition should occur over time, reflecting the provision of service.[41]

Question 2

Facts: Company A provides its customers with activity tracking or

[36] The staff believes that the vendor activities associated with the up-front fee, even if considered a deliverable to be evaluated under FASB ASC Subtopic 605–25, will rarely provide value to the customer on a standalone basis.

[37] *See* Concepts Statement 5, footnote 51, for a description of the "earning process."

[38] In a similar situation, lenders may collect nonrefundable loan origination fees in connection with lending activities. The FASB concluded in FASB ASC Subtopic 310–20, Receivables—Nonrefundable Fees and Other Costs, 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 (FASB ASC paragraph 310–20–35–2).

[39] 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).

[40] 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.

[41] Concepts Statement 5, paragraph 84(d).

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. 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 FASB ASC Subtopic 310–20, Receivables—Nonrefundable Fees and Other Costs, and that this arrangement qualifies as a single unit of accounting under FASB ASC Subtopic 605–25.[42]

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,[43] 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.

Question 3

Facts: Assume the same facts as in Question 2 above.

Question: Are the initial customer set-up costs incurred by Company A within the scope of FASB ASC Subtopic 720–15, Other Expenses—Start-Up Costs?

Interpretive Response: FASB ASC paragraph 720–15–15–4 states that the guidance does not address the financial reporting of costs incurred related to "ongoing customer acquisition costs, such as policy acquisition costs" addressed in FASB ASC Subtopic 944–30, Financial Services—Insurance—Acquisition Costs, and "loan origination costs" addressed in FASB ASC Subtopic 310–20. This guidance 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 FASB ASC Subtopic 720–15.

The staff believes that the incremental direct costs (the FASB ASC Master Glossary provides a definition) incurred related to the acquisition or origination of a customer contract in a transaction that results in the deferral of revenue, unless specifically provided for in the authoritative literature, may be either expensed as incurred or accounted for in accordance with FASB ASC paragraph 605–20–25–4 or FASB ASC paragraph 310–20–25–2. The staff believes the accounting policy chosen for these costs should be disclosed and applied consistently.

Question 4

Facts: Assume the same facts as in Question 2 above.

Question: What is the staff's view of the pool of contract acquisition and origination costs that are eligible for capitalization?

Interpretive Response: As noted in Question 3 above, the FASB ASC Master Glossary includes a definition of incremental direct costs. FASB ASC Subtopic 310–10, Receivables—Overall, provides further guidance on the types of costs eligible for capitalization as customer acquisition costs indicating that only costs that result from successful loan origination efforts are capitalized. Further, FASB ASC Subtopic 605–20, Revenue Recognition—Services, also requires capitalization of incremental direct customer acquisition costs. Although the facts of a particular situation should be analyzed closely to capture those costs that are truly direct and incremental, the staff generally would not object to an accounting policy that results in the capitalization of costs in accordance with FASB ASC Subtopic 310–20, Receivables—Nonrefundable Fees and Other Costs, or FASB ASC Subtopic 605–20. Registrants should disclose their policies for determining which costs to capitalize as contract acquisition and origination costs.

Question 5

Facts: Assume the same facts as in Question 2 above. Based on the guidance in Questions 2, 3 and 4 above, Company A has capitalized certain direct and incremental customer set-up costs associated with the deferred revenue.

Question: Over what period should Company A amortize these costs?

Interpretive Response: When both costs and revenue (in an amount equal to or greater than the costs) are deferred, the staff believes that the capitalized costs should be charged to expense proportionally and over the same period that deferred revenue is recognized as revenue.[44]

g. Deliverables Within an Arrangement

Question: If a company (the seller) has a patent to its intellectual property which it licenses to customers, the seller may represent and warrant to its licensees that it has a valid patent, and will defend and maintain that patent. Does that obligation to maintain and defend patent rights, in and of itself, constitute a deliverable to be evaluated under FASB ASC Subtopic 605–25?

Interpretive Response: No. Provided the seller has legal and valid patents upon entering the license arrangement, existing GAAP on licenses of intellectual property (*e.g.,* FASB ASC Subtopic 985–605, Software—Revenue Recognition, FASB ASC Subtopic 926–605, Entertainment—Films—Revenue Recognition, and FASB ASC Subtopic 928–605, Entertainment—Music—Revenue Recognition) does not indicate

[42] *See* Note 36, *supra.*

[43] *See* Note 39, *supra.*

[44] FASB ASC paragraph 605–20–25–4.

that an obligation to defend valid patents represents an additional deliverable to which a portion of an arrangement fee should be allocated in an arrangement that otherwise qualifies for sales-type accounting. While this clause may obligate the licenser to incur costs in the defense and maintenance of the patent, that obligation does not involve an additional deliverable to the customer. Defending the patent is generally consistent with the seller's representation in the license that such patent is legal and valid. Therefore, the staff would not consider a clause like this to represent an additional deliverable in the arrangement.[45]

4. Fixed or Determinable Sales Price

a. Refundable Fees for Services

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 is neither fixed nor determinable until the cancellation privileges lapse.[46] If the cancellation privileges expire ratably over a stated contractual term, the sales price is considered to become determinable ratably over the stated term.[47] 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 accounted for in accordance with FASB ASC Subtopic 605–15, Revenue Recognition—Products.[48]

Question 1

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 FASB ASC Subtopic 605–15) 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, FASB ASC Topic 860, Transfers and Servicing, 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.[49] 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 FASB ASC Subtopic 605–15 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,[50] 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 FASB ASC Subtopic 605–15. 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 FASB ASC Subtopic 605–15 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.

[45] Note, however, the staff believes that this obligation qualifies as a guarantee within the scope of FASB ASC Topic 460, subject to a scope exception from the initial recognition and measurement provisions.

[46] FASB ASC paragraph 985–605–25–37.

[47] *Ibid.*

[48] *Ibid.*

[49] FASB ASC paragraph 405–20–40–1 (Liabilities Topic).

[50] FASB ASC paragraph 605–15–15–3.

The staff believes that, because service arrangements are specifically excluded from the scope of FASB ASC Subtopic 605–15, the most direct authoritative literature to be applied to the extinguishment of obligations under such contracts is FASB ASC Topic 860. As noted above, because the refund privilege extends to the end of the contract term irrespective of the amount of the service performed, FASB ASC Topic 860 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 FASB ASC Subtopic 605–15 and that practice did not change when FASB ASC Topic 860 became effective. Reasonable people held, and continue to hold, different views about the application of the accounting literature.

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: [51]

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.[52] Either of the following two items would be considered indicative of an inability to make reliable estimates: (1) recurring, 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 statements [53] 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 remote [54] 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,[55] 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.

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.[56]

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 from third parties. The costs associated with the vouchers should be expensed when distributed. Advertising costs to solicit members should be accounted for in accordance with FASB ASC Subtopic 720–35, Other Expenses—Advertising Costs. 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

[51] The staff will question further analogies to the guidance in FASB ASC Subtopic 605–15 for transactions expressly excluded from its scope.

[52] 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."

[53] 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.

[54] The term "remote" is used here with the same definition as used in the FASB ASC Master Glossary.

[55] FASB ASC paragraph 605–15–25–3 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.

[56] The staff believes deferred costs being amortized on a basis consistent with the deferred revenue should be similarly adjusted. Such an approach is generally consistent with the amortization methodology in FASB ASC paragraph 310–20–35–26.

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.[57] All costs other than incremental direct costs (*e.g.,* indirect costs) should be expensed as incurred.

Question 2

Question: Will the staff accept an analogy to FASB ASC Subtopic 605–15 for service transactions subject to customer cancellation privileges other than those specifically addressed in the previous question?

Interpretive Response: The staff has accepted the analogy in limited circumstances due to the existence of a large pool of homogeneous transactions and satisfaction of the criteria in the previous question. Examples of other arrangements involving customer cancellation privileges and refundable service fees that the staff has addressed include the following:

- A leasing broker whose commission from the lessor upon a commercial tenant's signing of a lease agreement is refundable (or in some cases, is not due) under lessor cancellation privileges if the tenant fails to move into the leased premises by a specified date.
- A talent agent whose fee receivable from its principal (*i.e.,* a celebrity) for arranging a celebrity endorsement for a five-year term is cancelable by the celebrity if the celebrity breaches the endorsement contract with its customer.
- An insurance agent whose commission received from the insurer upon selling an insurance policy is refundable in whole for the 30-day period that state law permits the consumer to repudiate the contract and then refundable on a declining pro rata basis until the consumer has made six monthly payments.

In the first two of these cases, the staff advised the registrants that the portion of revenue subject to customer cancellation and refund must be deferred until no longer subject to that contingency because the registrants did not have an ability to make reliable estimates of customer cancellations due to the lack of a large pool of homogeneous transactions. In the case of the insurance agent, however, the particular registrant demonstrated that it had a sufficient history of homogeneous transactions with the same characteristics from which to reliably estimate contract cancellations and satisfy all the criteria specified in the previous question. Accordingly, the staff did not object to that registrant's policy of recognizing its sales commission as revenue when its performance was complete, with an appropriate allowance for estimated cancellations.

Question 3

Question: Must a registrant analogize to FASB ASC Subtopic 605–15, or may it choose to defer all revenue until the refund period lapses as suggested by FASB ASC Topic 860 even if the criteria above for analogy to FASB ASC Subtopic 605–15 are met?

Interpretive Response: The analogy to FASB ASC Subtopic 605–15 is presented as an alternative that would be acceptable to the staff when the listed conditions are met. However, a registrant may choose to defer all revenue until the refund period lapses. The policy chosen should be disclosed and applied consistently.

Question 4

Question: May a registrant that meets the above criteria for reliable estimates of cancellations choose at some point in the future to change from the FASB ASC Subtopic 605–15 method to the FASB ASC Topic 860 method of accounting for these refundable fees? May a registrant change from the FASB ASC Topic 860 method to the FASB ASC Subtopic 605–15 method?

Interpretive Response: The staff believes that FASB ASC Topic 860 provides a preferable accounting model for service transactions subject to potential refunds. Therefore, the staff would not object to a change from the FASB ASC Subtopic 605–15 method to the FASB ASC Topic 860 method. However, if a registrant had previously chosen the FASB ASC Topic 860 method, the staff would object to a change to the FASB ASC Subtopic 605–15 method.

Question 5

Question: Is there a minimum level of customers that must be projected not to cancel before use of FASB ASC Subtopic 605–15 type accounting is appropriate?

Interpretive Response: FASB ASC Subtopic 605–15 does not include any such minimum. Therefore, the staff does not believe that a minimum must apply in service transactions either. However, as the refund rate increases, it may be increasingly difficult to make reasonable and reliable estimates of cancellation rates.

Question 6

Question: When a registrant first determines that reliable estimates of cancellations of service contracts can be made (*e.g.,* two years of historical evidence becomes available), how should the change from the complete deferral method to the method of recognizing revenue, net of estimated cancellations, over time be reflected?

Interpretive Response: Changes in the ability to meet the criteria set forth above should be accounted for in the manner described in FASB ASC paragraph 605–15–25–1, which addresses the accounting when a company experiences a change in the ability to make reasonable estimates of future product returns.

b. Estimates and Changes in Estimates

Accounting for revenues and costs of revenues requires estimates in many cases; those estimates sometimes change. Registrants should ensure that they have appropriate internal controls and adequate books and records that will result in timely identification of necessary changes in estimates that should be reflected in the financial statements and notes thereto.

Question 1

Facts: FASB ASC paragraph 605–15–25–3 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.[58] The paragraph concludes by stating "other factors may preclude a reasonable estimate."

Question: What "other factors," in addition to those listed in FASB ASC paragraph 605–15–25–3, 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

[57] FASB ASC paragraphs 310–20–25–2 and 605–20–25–4 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* SAB Topic 13.A.3.f. Question 3.

[58] These factors include "(a) the susceptibility of the product to significant external factors, such as technological obsolescence or changes in demand, (b) relatively 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."

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 (7) 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, which 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 FASB ASC paragraphs 605–15–25–1 and 605–15–25–3, no revenue may be recognized until those conditions are subsequently met or the return privilege has substantially expired, whichever occurs first.[59] Simply deferring recognition of the gross margin on the transaction is not appropriate.

Question 2

Question: Is the requirement cited in the previous question for "reliable" estimates meant to imply a new, higher requirement than the "reasonable" estimates discussed in FASB ASC Subtopic 605–15?

Interpretive Response: No. "Reliability" of financial information is one of the qualities of accounting information discussed in Concepts Statement 2, *Qualitative Characteristics of Accounting Information.* The staff's expectation that estimates be reliable does not change the existing requirement of FASB ASC Subtopic 605–15. If management cannot develop an estimate that is sufficiently reliable for use by investors, the staff believes it cannot make a reasonable estimate meeting the requirements of that standard.

Question 3

Question: Does the staff expect registrants to apply the guidance in Question 1 of Topic 13.A.4(a) above to sales of tangible goods and other transactions specifically within the scope of FASB ASC Subtopic 605–15?

Interpretive Response: The specific guidance above does not apply to transactions within the scope of FASB ASC Subtopic 605–15. The views set forth in Question 1 of Topic 13.A.4(a) are applicable to the service transactions discussed in that Question. Service transactions are explicitly outside the scope of FASB ASC Subtopic 605–15.

Question 4

Question: Question 1 of Topic 13.A.4(a) above states that the staff would expect a two-year history of selling a new service in order to be able to make reliable estimates of cancellations. How long a history does the staff believe is necessary to estimate returns in a product sale transaction that is within the scope of FASB ASC Subtopic 605–15?

Interpretive Response: The staff does not believe there is any specific length of time necessary in a product transaction. However, FASB ASC Subtopic 605–15 states that returns must be subject to reasonable estimation. Preparers and auditors should be skeptical of estimates of product returns when little history with a particular product line exists, when there is inadequate verifiable evidence of historical experience, or when there are inadequate internal controls that ensure the reliability and timeliness of the reporting of the appropriate historical information. Start-up companies and companies selling new or significantly modified products are frequently unable to develop the requisite historical data on which to base estimates of returns.

Question 5

Question: If a company selling products subject to a right of return concludes that it cannot reasonably estimate the actual return rate due to its limited history, but it can conservatively estimate the maximum possible returns, does the staff believe that the company may recognize revenue for the portion of the sales that exceeds the maximum estimated return rate?

Interpretive Response: No. If a reasonable estimate of future returns cannot be made, FASB ASC Subtopic 605–15 requires that revenue not be recognized until the return period lapses or a reasonable estimate can be made.[60] Deferring revenue recognition based on the upper end of a wide range of potential return rates is inconsistent with the provisions of FASB ASC Subtopic 605–15.

c. Contingent Rental Income

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.[61]

FASB ASC paragraph 840–20–25–1 states that "[r]ent shall be charged to expense by lessees (reported as income by lessors) over the lease term as it becomes payable (receivable). If rental payments are not made on a straight-line basis, rental expense nevertheless shall be recognized on a straight-line basis unless another systematic and rational basis is more representative of the time pattern in which use benefit is derived from the leased property, in which case that basis shall be used."

FASB ASC paragraph 840–10–25–4 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." FASB ASC paragraph 840–10–55–38 provides the following example of determining contingent rentals:

Assume that a lease agreement for retail store space stipulates a monthly base rental of

[59] FASB ASC paragraph 605–15–25–1.

[60] FASB ASC subparagraph 605–15–25–1(f).

[61] Lessees should follow the guidance established in FASB ASC Subtopic 840–10.

$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.

FASB ASC Section 840–20–25 addresses whether it is appropriate for lessors in operating leases to recognize scheduled rent increases on a basis other than as required in FASB ASC paragraph 840–20–25–1. FASB ASC subparagraph 840–20–25–2(a) 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." 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. FASB ASC subparagraph 840–20–25–2(b) states "[i]f the lessee and lessor eliminate the risk of variable payments inherent in contingent rentals by agreeing to scheduled rent increases, the accounting shall reflect those different circumstances."

The example provided in FASB ASC paragraph 840–10–55–39 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. FASB ASC paragraph 840–20–25–2 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 FASB ASC Section 840–20–25 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.

d. Claims Processing and Billing Services

Facts: Company M performs claims processing and medical billing services for healthcare providers. In this role, Company M is responsible for preparing and submitting claims to third-party payers, tracking outstanding billings, and collecting amounts billed. Company M's fee is a fixed percentage (*e.g.,* five percent) of the amount collected. If no collections are made, no fee is due to Company M. Company M has historical evidence indicating that the third-party payers pay 85 percent of the billings submitted with no further effort by Company M. Company M has determined that the services performed under the arrangement are a single unit of accounting.

Question: May Company M recognize as revenue its five percent fee on 85 percent of the gross billings at the time it prepares and submits billings, or should it wait until collections occur to recognize any revenue?

Interpretive Response: The staff believes that Company M must wait until collections occur before recognizing revenue. Before the third-party payer has remitted payment to Company M's customers for the services billed, Company M is not entitled to any revenue. That is, its revenue is not yet realized or realizable.[62] Until Company M's customers collect on the billings, Company M has not performed the requisite activity under its contract to be entitled to a fee.[63] Further, no amount of the fee is fixed or determinable or collectible until Company M's customers collect on the billings.

B. Disclosures

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 FASB ASC Topic 235, Notes to Financial Statements. FASB ASC paragraph 235–10–50–3 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 units of accounting, such as a product and service, the accounting policy should clearly state the accounting policy for each unit of accounting as well as how units of accounting are determined and valued. In addition, the staff believes that changes in estimated returns recognized in accordance with FASB ASC Subtopic 605–15 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.[64] 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.[65] This includes unusual or

[62] Concepts Statement 5, paragraph 83(a).

[63] Concepts Statement 5, paragraph 83(b).

[64] *See* Regulation S–X, Article 5–03(1) and (2).

[65] *See* Regulation S–K, Item 303 and FRR 36.

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." [66] 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.)[67]
- 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).[68]

[66] FRR 36; *See also* In the Matter of Caterpillar Inc., AAER 363 (March 31, 1992).

[67] FASB ASC Subtopic 825–10, Financial Instruments—Overall.

[68] Gains or losses from the sale of assets should be reported as "other general expenses" pursuant to Regulation S–X, Article 5–03(6). Any material item should be stated separately.

TOPIC 14: SHARE–BASED PAYMENT

The interpretations in this SAB express views of the staff regarding the interaction between FASB ASC Topic 718, Compensation—Stock Compensation, and certain SEC rules and regulations and provide the staff's views regarding the valuation of share-based payment arrangements for public companies. FASB ASC Topic 718 is based on the underlying accounting principle that compensation cost resulting from share-based payment transactions be recognized in financial statements at fair value.[1] Recognition of compensation cost at fair value will provide investors and other users of financial statements with more complete and comparable financial information.[2]

FASB ASC Topic 718 addresses a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans.

FASB ASC Topic 718 replaces guidance as originally issued in 1995, that established as preferable, but did not require, a fair-value-based method of accounting for share-based payment transactions with employees.

The staff believes the guidance in this SAB will assist issuers in their initial implementation of FASB ASC Topic 718 and enhance the information received by investors and other users of financial statements, thereby assisting them in making investment and other decisions. This SAB includes interpretive guidance related to share-based payment transactions with nonemployees, the transition from nonpublic to public entity [3] status, valuation methods (including assumptions such as expected volatility and expected term), the accounting for certain redeemable financial instruments issued under share-based payment arrangements, the classification of compensation expense, non-GAAP financial measures, first-time adoption of FASB ASC Topic 718 in an interim period, capitalization of compensation cost related to share-based payment arrangements, the accounting for income tax effects of share-based payment arrangements upon adoption of FASB ASC Topic 718, the modification of employee share options prior to adoption of FASB ASC Topic 718 and disclosures in MD&A subsequent to adoption of FASB ASC Topic 718.

The staff recognizes that there is a range of conduct that a reasonable issuer might use to make estimates and valuations and otherwise implement FASB ASC Topic 718, and the interpretive guidance provided by this SAB, particularly during the period of the Topic's initial implementation. Thus, throughout this SAB the use of the terms "reasonable" and "reasonably" is not meant to imply a single conclusion or methodology, but to encompass the full range of potential conduct, conclusions or methodologies upon which an issuer may reasonably base its valuation decisions. Different conduct, conclusions or methodologies by different issuers in a given situation does not of itself raise an inference that any of those issuers is acting unreasonably. While the zone of reasonable conduct is not unlimited, the staff expects that it will be rare when there is only one acceptable choice in estimating the fair value of share-based payment arrangements under the provisions of FASB ASC Topic 718 and the interpretive guidance provided by this SAB in any given situation. In addition, as discussed in the Interpretive Response to Question 1 of Section C, Valuation Methods, estimates of fair value are not intended to predict actual future events, and subsequent events are not indicative of the reasonableness of the original estimates of fair value made under FASB ASC Topic 718. Over time, as issuers and accountants gain more experience in applying FASB ASC Topic 718 and the guidance provided in this SAB, the staff anticipates that particular approaches may begin to emerge as best practices and that the range of reasonable conduct, conclusions and methodologies will likely narrow.

* * * * *

A. Share-Based Payment Transactions with Nonemployees

Question: Are share-based payment transactions with nonemployees included in the scope of FASB ASC Topic 718?

Interpretive Response: Only certain aspects of the accounting for share-based payment transactions with nonemployees are explicitly addressed by FASB ASC Topic 718. This Topic explicitly:

- Establishes fair value as the measurement objective in accounting for all share-based payments; [4] and
- Requires that an entity record the value of a transaction with a

[1] FASB ASC paragraphs 718–10–30–2 through 718–10–30–4.

[2] [Original footnote removed by SAB 114.]

[3] Defined in the FASB ASC Master Glossary.

[4] FASB ASC paragraph 718–10–30–2.

nonemployee based on the more reliably measurable fair value of either the good or service received or the equity instrument issued.[5]

FASB ASC Topic 718 does not supersede any of the authoritative literature that specifically addresses accounting for share-based payments with nonemployees. For example, FASB ASC Topic 718 does not specify the measurement date for share-based payment transactions with nonemployees when the measurement of the transaction is based on the fair value of the equity instruments issued.[6] For determining the measurement date of equity instruments issued in share-based transactions with nonemployees, a company should refer to FASB ASC Subtopic 505–50, Equity—Equity Based Payments to Non-Employees.

With respect to questions regarding nonemployee arrangements that are not specifically addressed in other authoritative literature, the staff believes that the application of guidance in FASB ASC Topic 718 would generally result in relevant and reliable financial statement information. As such, the staff believes it would generally be appropriate for entities to apply the guidance in FASB ASC Topic 718 by analogy to share-based payment transactions with nonemployees unless other authoritative accounting literature more clearly addresses the appropriate accounting, or the application of the guidance in FASB ASC Topic 718 would be inconsistent with the terms of the instrument issued to a nonemployee in a share-based payment arrangement.[7] For example, the staff believes the guidance in FASB ASC Topic 718 on certain transactions with related parties or other holders of an economic interest in the entity would generally be applicable to share-based payment transactions with nonemployees. The staff encourages registrants that have additional questions related to accounting for share-based payment transactions with nonemployees to discuss those questions with the staff.

B. Transition From Nonpublic to Public Entity Status

Facts: Company A is a nonpublic entity [8] that first files a registration statement with the SEC to register its equity securities for sale in a public market on January 2, 20X8.[9] As a nonpublic entity, Company A had been assigning value to its share options [10] under the calculated value method prescribed by FASB ASC Topic 718, Compensation—Stock Compensation,[11] and had elected to measure its liability awards based on intrinsic value. Company A is considered a public entity on January 2, 20X8 when it makes its initial filing with the SEC in preparation for the sale of its shares in a public market.

Question 1: How should Company A account for the share options that were granted to its employees prior to January 2, 20X8 for which the requisite service has not been rendered by January 2, 20X8?

Interpretive Response: Prior to becoming a public entity, Company A had been assigning value to its share options under the calculated value method. The staff believes that Company A should continue to follow that approach for those share options that were granted prior to January 2, 20X8, unless those share options are subsequently modified, repurchased or cancelled.[12] If the share options are subsequently modified, repurchased or cancelled, Company A would assess the event under the public company provisions of FASB ASC Topic 718. For example, if Company A modified the share options on February 1, 20X8, any incremental compensation cost would be measured under FASB ASC subparagraph 718–20–35–3(a), as the fair value of the modified share options over the fair value of the original share options measured immediately before the terms were modified.[13]

Question 2: How should Company A account for its liability awards granted to its employees prior to January 2, 20X8 which are fully vested but have not been settled by January 2, 20X8?

Interpretive Response: As a nonpublic entity, Company A had elected to measure its liability awards subject to FASB ASC Topic 718 at intrinsic value.[14] When Company A becomes a public entity, it should measure the liability awards at their fair value determined in accordance with FASB ASC Topic 718.[15] In that reporting period there will be an incremental amount of measured cost for the difference between fair value as determined under FASB ASC Topic 718 and intrinsic value. For example, assume the intrinsic value in the period ended December 31, 20X7 was $10 per award. At the end of the first reporting period ending after January 2, 20X8 (when Company A becomes a public entity), assume the intrinsic value of the award is $12 and the fair value as determined in accordance with FASB ASC Topic 718 is $15. The measured cost in the first reporting period after December 31, 20X7 would be $5.[16]

Question 3: After becoming a public entity, may Company A retrospectively apply the fair-value-based method to its awards that were granted prior to the date Company A became a public entity?

Interpretive Response: No. Before becoming a public entity, Company A did not use the fair-value-based method for either its share options or its liability awards granted to the Company's employees. The staff does not believe it is appropriate for Company A to apply the fair-value-based method on a retrospective basis, because it would require the entity to make estimates of a prior period, which, due to hindsight, may vary significantly from estimates

[5] *Ibid.*

[6] [Original footnote removed by SAB 114.]

[7] For example, due to the nature of specific terms in employee share options, including nontransferability, nonhedgability and the truncation of the contractual term due to post-vesting service termination, FASB ASC Topic 718 requires that when valuing an employee share option under the Black-Scholes-Merton framework, the fair value of an employee share option be based on the option's expected term rather than the contractual term. If these features (*i.e.,* nontransferability, nonhedgability and the truncation of the contractual term) were not present in a nonemployee share option arrangement, the use of an expected term assumption shorter than the contractual term would generally not be appropriate in estimating the fair value of the nonemployee share options.

[8] Defined in the FASB ASC Master Glossary.

[9] For the purposes of these illustrations, assume all of Company A's equity-based awards granted to its employees were granted after the adoption of FASB ASC Topic 718.

[10] For purposes of this staff accounting bulletin, the phrase "share options" is used to refer to "share options or similar instruments."

[11] FASB ASC paragraph 718–10–30–20 requires a nonpublic entity to use the calculated value method when it is not able to reasonably estimate the fair value of its equity share options and similar instruments because it is not practicable for it to estimate the expected volatility of its share price. FASB ASC paragraph 718–10–55–51 indicates that a nonpublic entity may be able to identify similar public entities for which share or option price information is available and may consider the historical, expected, or implied volatility of those entities' share prices in estimating expected volatility. The staff would expect an entity that becomes a public entity and had previously measured its share options under the calculated value method to be able to support its previous decision to use calculated value and to provide the disclosures required by FASB ASC subparagraph 718–10–50–2(f)(2)(ii).

[12] This view is consistent with the FASB's basis for rejecting full retrospective application of FASB ASC Topic 718 as described in the basis for conclusions of Statement 123R, paragraph B251.

[13] FASB ASC paragraph 718–20–55–94. The staff believes that because Company A is a public entity as of the date of the modification, it would be inappropriate to use the calculated value method to measure the original share options immediately before the terms were modified.

[14] FASB ASC paragraph 718–30–30–2.

[15] FASB ASC paragraph 718–30–35–3.

[16] $15 fair value less $10 intrinsic value equals $5 of incremental cost.

that would have been made contemporaneously in prior periods.[17]

Question 4: Upon becoming a public entity, what disclosures should Company A consider in addition to those prescribed by FASB ASC Topic 718?[18]

Interpretive Response: In the registration statement filed on January 2, 20X8, Company A should clearly describe in MD&A the change in accounting policy that will be required by FASB ASC Topic 718 in subsequent periods and the reasonably likely material future effects.[19] In subsequent filings, Company A should provide financial statement disclosure of the effects of the changes in accounting policy. In addition, Company A should consider the applicability of SEC Release No. FR–60[20] and Section V, "Critical Accounting Estimates," in SEC Release No. FR–72[21] regarding critical accounting policies and estimates in MD&A.

C. Valuation Methods

FASB ASC paragraph 718–10–30–6 (Compensation—Stock Compensation Topic) indicates that the measurement objective for equity instruments awarded to employees is to estimate at the grant date the fair value of the equity instruments the entity is obligated to issue when employees have rendered the requisite service and satisfied any other conditions necessary to earn the right to benefit from the instruments. The Topic also states that observable market prices of identical or similar equity or liability instruments in active markets are the best evidence of fair value and, if available, should be used as the basis for the measurement for equity and liability instruments awarded in a share-based payment transaction with employees.[22] However, if observable market prices of identical or similar equity or liability instruments are not available, the fair value shall be estimated by using a valuation technique or model that complies with the measurement objective, as described in FASB ASC Topic 718.[23]

Question 1: If a valuation technique or model is used to estimate fair value, to what extent will the staff consider a company's estimates of fair value to be materially misleading because the estimates of fair value do not correspond to the value ultimately realized by the employees who received the share options?

Interpretive Response: The staff understands that estimates of fair value of employee share options, while derived from expected value calculations, cannot predict actual future events.[24] The estimate of fair value represents the measurement of the cost of the employee services to the company. The estimate of fair value should reflect the assumptions marketplace participants would use in determining how much to pay for an instrument on the date of the measurement (generally the grant date for equity awards). For example, valuation techniques used in estimating the fair value of employee share options may consider information about a large number of possible share price paths, while, of course, only one share price path will ultimately emerge. If a company makes a good faith fair value estimate in accordance with the provisions of FASB ASC Topic 718 in a way that is designed to take into account the assumptions that underlie the instrument's value that marketplace participants would reasonably make, then subsequent future events that affect the instrument's value do not provide meaningful information about the quality of the original fair value estimate. As long as the share options were originally so measured, changes in an employee share option's value, no matter how significant, subsequent to its grant date do not call into question the reasonableness of the grant date fair value estimate.

Question 2: In order to meet the fair value measurement objective in FASB ASC Topic 718, are certain valuation techniques preferred over others?

Interpretive Response: FASB ASC paragraph 718–10–55–17 clarifies that the Topic does not specify a preference for a particular valuation technique or model. As stated in FASB ASC paragraph 718–10–55–11 in order to meet the fair value measurement objective, a company should select a valuation technique or model that (a) is applied in a manner consistent with the fair value measurement objective and other requirements of FASB ASC Topic 718, (b) is based on established principles of financial economic theory and generally applied in that field and (c) reflects all substantive characteristics of the instrument.

The chosen valuation technique or model must meet all three of the requirements stated above. In valuing a particular instrument, certain techniques or models may meet the first and second criteria but may not meet the third criterion because the techniques or models are not designed to reflect certain characteristics contained in the instrument. For example, for a share option in which the exercisability is conditional on a specified increase in the price of the underlying shares, the Black-Scholes-Merton closed-form model would not generally be an appropriate valuation model because, while it meets both the first and second criteria, it is not designed to take into account that type of market condition.[25]

Further, the staff understands that a company may consider multiple techniques or models that meet the fair value measurement objective before making its selection as to the appropriate technique or model. The staff would not object to a company's choice of a technique or model as long as the technique or model meets the fair value measurement objective. For example, a company is not required to use a lattice model simply because that model was the most complex of the models the company considered.

Question 3: In subsequent periods, may a company change the valuation technique or model chosen to value instruments with similar characteristics?[26]

Interpretive Response: As long as the new technique or model meets the fair value measurement objective as described in Question 2 above, the staff would not object to a company changing its valuation technique or model.[27] A change in the valuation technique or model used to meet the fair value

[17] This view is consistent with the FASB's basis for rejecting full retrospective application of FASB ASC Topic 718 as described in the basis for conclusions of Statement 123R, paragraph B251.

[18] FASB ASC Section 718–10–50.

[19] *See generally* SEC Release No. FR–72, "Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations."

[20] SEC Release No. FR–60, "Cautionary Advice Regarding Disclosure About Critical Accounting Policies."

[21] SEC Release No. FR–72, "Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations."

[22] FASB ASC paragraph 718–10–55–10.

[23] FASB ASC paragraph 718–10–55–11.

[24] FASB ASC paragraph 718–10–55–15 states "The fair value of those instruments at a single point in time is not a forecast of what the estimated fair value of those instruments may be in the future."

[25] *See* FASB ASC paragraphs 718–10–55–16 and 718–10–55–20.

[26] FASB ASC paragraph 718–10–55–17 indicates that an entity may use different valuation techniques or models for instruments with different characteristics.

[27] The staff believes that a company should take into account the reason for the change in technique or model in determining whether the new technique or model meets the fair value measurement objective. For example, changing a technique or model from period to period for the sole purpose of lowering the fair value estimate of a share option would not meet the fair value measurement objective of the Topic.

measurement objective would not be considered a change in accounting principle. As such, a company would not be required to file a preferability letter from its independent accountants as described in Rule 10–01(b)(6) of Regulation S–X when it changes valuation techniques or models.[28] However, the staff would not expect that a company would frequently switch between valuation techniques or models, particularly in circumstances where there was no significant variation in the form of share-based payments being valued. Disclosure in the footnotes of the basis for any change in technique or model would be appropriate.[29]

Question 4: Must every company that issues share options or similar instruments hire an outside third party to assist in determining the fair value of the share options?

Interpretive Response: No. However, the valuation of a company's share options or similar instruments should be performed by a person with the requisite expertise.

D. Certain Assumptions Used in Valuation Methods

FASB ASC Topic 718's (Compensation—Stock Compensation Topic) fair value measurement objective for equity instruments awarded to employees is to estimate the grant-date fair value of the equity instruments that the entity is obligated to issue when employees have rendered the requisite service and satisfied any other conditions necessary to earn the right to benefit from the instruments.[30] In order to meet this fair value measurement objective, management will be required to develop estimates regarding the expected volatility of its company's share price and the exercise behavior of its employees. The staff is providing guidance in the following sections related to the expected volatility and expected term assumptions to assist public entities in applying those requirements.

The staff understands that companies may refine their estimates of expected volatility and expected term as a result of the guidance provided in FASB ASC Topic 718 and in sections (1) and (2) below. Changes in assumptions during the periods presented in the financial statements should be disclosed in the footnotes.[31]

1. Expected Volatility

FASB ASC paragraph 718–10–55–36 states, "Volatility is a measure of the amount by which a financial variable, such as share price, has fluctuated (historical volatility) or is expected to fluctuate (expected volatility) during a period. Option-pricing models require an estimate of expected volatility as an assumption because an option's value is dependent on potential share returns over the option's term. The higher the volatility, the more the returns on the share can be expected to vary—up or down. Because an option's value is unaffected by expected negative returns on the shares, other things [being] equal, an option on a share with higher volatility is worth more than an option on a share with lower volatility."

Facts: Company B is a public entity whose common shares have been publicly traded for over twenty years. Company B also has multiple options on its shares outstanding that are traded on an exchange ("traded options"). Company B grants share options on January 2, 20X6.

Question 1: What should Company B consider when estimating expected volatility for purposes of measuring the fair value of its share options?

Interpretive Response: FASB ASC Topic 718 does not specify a particular method of estimating expected volatility. However, the Topic does clarify that the objective in estimating expected volatility is to ascertain the assumption about expected volatility that marketplace participants would likely use in determining an exchange price for an option.[32] FASB ASC Topic 718 provides a list of factors entities should consider in estimating expected volatility.[33] Company B may begin its process of estimating expected volatility by considering its historical volatility.[34] However, Company B should also then consider, based on available information, how the expected volatility of its share price may differ from historical volatility.[35] Implied volatility [36] can be useful in estimating expected volatility because it is generally reflective of both historical volatility and expectations of how future volatility will differ from historical volatility.

The staff believes that companies should make good faith efforts to identify and use sufficient information in determining whether taking historical volatility, implied volatility or a combination of both into account will result in the best estimate of expected volatility. The staff believes companies that have appropriate traded financial instruments from which they can derive an implied volatility should generally consider this measure. The extent of the ultimate reliance on implied volatility will depend on a company's facts and circumstances; however, the staff believes that a company with actively traded options or other financial instruments with embedded options [37] generally could place greater (or even exclusive) reliance on implied volatility. (*See* the Interpretive Responses to Questions 3 and 4 below.)

The process used to gather and review available information to estimate expected volatility should be applied consistently from period to period. When circumstances indicate the availability of new or different information that would be useful in estimating expected volatility, a company should incorporate that information.

Question 2: What should Company B consider if computing historical volatility? [38]

Interpretive Response: The following should be considered in the computation of historical volatility:

1. Method of Computing Historical Volatility—

The staff believes the method selected by Company B to compute its historical volatility should produce an estimate that is representative of Company B's expectations about its future volatility over the expected (if using a Black-Scholes-Merton closed-form model) or contractual (if using a lattice model) term [39] of its employee share options. Certain methods may not be appropriate

[28] FASB ASC paragraph 718–10–55–27.

[29] *See generally* FASB ASC paragraph 718–10–50–1.

[30] FASB ASC paragraph 718–10–55–4.

[31] FASB ASC paragraph 718–10–50–2.

[32] FASB ASC paragraph 718–10–55–35.

[33] FASB ASC paragraph 718–10–55–37.

[34] FASB ASC paragraph 718–10–55–40.

[35] *Ibid.*

[36] Implied volatility is the volatility assumption inherent in the market prices of a company's traded options or other financial instruments that have option-like features. Implied volatility is derived by entering the market price of the traded financial instrument, along with assumptions specific to the financial options being valued, into a model based on a constant volatility estimate (*e.g.,* the Black-Scholes-Merton closed-form model) and solving for the unknown assumption of volatility.

[37] The staff believes implied volatility derived from embedded options can be utilized in determining expected volatility if, in deriving the implied volatility, the company considers all relevant features of the instruments (*e.g.,* value of the host instrument, value of the option, *etc.*). The staff believes the derivation of implied volatility from other than simple instruments (*e.g.,* a simple convertible bond) can, in some cases, be impracticable due to the complexity of multiple features.

[38] *See* FASB ASC paragraph 718–10–55–37.

[39] For purposes of this staff accounting bulletin, the phrase "expected or contractual term, as applicable" has the same meaning as the phrase "expected (if using a Black-Scholes-Merton closed-form model) or contractual (if using a lattice model) term of an employee share option."

for longer term employee share options if they weight the most recent periods of Company B's historical volatility much more heavily than earlier periods.[40] For example, a method that applies a factor to certain historical price intervals to reflect a decay or loss of relevance of that historical information emphasizes the most recent historical periods and thus would likely bias the estimate to this recent history.[41]

2. Amount of Historical Data—

FASB ASC subparagraph 718–10–55–37(a) indicates entities should consider historical volatility over a period generally commensurate with the expected or contractual term, as applicable, of the share option. The staff believes Company B could utilize a period of historical data longer than the expected or contractual term, as applicable, if it reasonably believes the additional historical information will improve the estimate. For example, assume Company B decided to utilize a Black-Scholes-Merton closed-form model to estimate the value of the share options granted on January 2, 20X6 and determined that the expected term was six years. Company B would not be precluded from using historical data longer than six years if it concludes that data would be relevant.

3. Frequency of Price Observations—

FASB ASC subparagraph 718–10–55–37(d) indicates an entity should use appropriate and regular intervals for price observations based on facts and circumstances that provide the basis for a reasonable fair value estimate. Accordingly, the staff believes Company B should consider the frequency of the trading of its shares and the length of its trading history in determining the appropriate frequency of price observations. The staff believes using daily, weekly or monthly price observations may provide a sufficient basis to estimate expected volatility if the history provides enough data points on which to base the estimate.[42] Company B should select a consistent point in time within each interval when selecting data points.[43]

4. Consideration of Future Events—

The objective in estimating expected volatility is to ascertain the assumptions that marketplace participants would likely use in determining an exchange price for an option.[44] Accordingly, the staff believes that Company B should consider those future events that it reasonably concludes a marketplace participant would also consider in making the estimation. For example, if Company B has recently announced a merger with a company that would change its business risk in the future, then it should consider the impact of the merger in estimating the expected volatility if it reasonably believes a marketplace participant would also consider this event.

5. Exclusion of Periods of Historical Data—

In some instances, due to a company's particular business situations, a period of historical volatility data may not be relevant in evaluating expected volatility.[45] In these instances, that period should be disregarded. The staff believes that if Company B disregards a period of historical volatility, it should be prepared to support its conclusion that its historical share price during that previous period is not relevant to estimating expected volatility due to one or more discrete and specific historical events and that similar events are not expected to occur during the expected term of the share option. The staff believes these situations would be rare.

Question 3: What should Company B consider when evaluating the extent of its reliance on the implied volatility derived from its traded options?

Interpretive Response: To achieve the objective of estimating expected volatility as stated in FASB ASC paragraphs 718–10–55–35 through 718–10–55–41, the staff believes Company B generally should consider the following in its evaluation: 1) the volume of market activity of the underlying shares and traded options; 2) the ability to synchronize the variables used to derive implied volatility; 3) the similarity of the exercise prices of the traded options to the exercise price of the employee share options; and 4) the similarity of the length of the term of the traded and employee share options.[46]

1. Volume of Market Activity—

The staff believes Company B should consider the volume of trading in its underlying shares as well as the traded options. For example, prices for instruments in actively traded markets are more likely to reflect a marketplace participant's expectations regarding expected volatility.

2. Synchronization of the Variables—

Company B should synchronize the variables used to derive implied volatility. For example, to the extent reasonably practicable, Company B should use market prices (either traded prices or the average of bid and asked quotes) of the traded options and its shares measured at the same point in time. This measurement should also be synchronized with the grant of the employee share options; however, when this is not reasonably practicable, the staff believes Company B should derive implied volatility as of a point in time as close to the grant of the employee share options as reasonably practicable.

3. Similarity of the Exercise Prices—

The staff believes that when valuing an at-the-money employee share option, the implied volatility derived from at- or near-the-money traded options generally would be most relevant.[47] If, however, it is not possible to find at- or near-the-money traded options, Company B should select multiple traded options with an average exercise price close to the exercise price of the employee share option.[48]

[40] FASB ASC subparagraph 718–10–55–37(a) states that entities should consider historical volatility over a period generally commensurate with the expected or contractual term, as applicable, of the share option. Accordingly, the staff believes methods that place extreme emphasis on the most recent periods may be inconsistent with this guidance.

[41] Generalized Autoregressive Conditional Heteroskedasticity ("GARCH") is an example of a method that demonstrates this characteristic.

[42] Further, if shares of a company are thinly traded the staff believes the use of weekly or monthly price observations would generally be more appropriate than the use of daily price observations. The volatility calculation using daily observations for such shares could be artificially inflated due to a larger spread between the bid and asked quotes and lack of consistent trading in the market.

[43] FASB ASC paragraph 718–10–55–40 states that a company should establish a process for estimating expected volatility and apply that process consistently from period to period. In addition, FASB ASC paragraph 718–10–55–27 indicates that assumptions used to estimate the fair value of instruments granted to employees should be determined in a consistent manner from period to period.

[44] FASB ASC paragraph 718–10–55–35.

[45] FASB ASC paragraph 718–10–55–37.

[46] *See generally* Options, Futures, and Other Derivatives by John C. Hull (Prentice Hall, 5th Edition, 2003).

[47] Implied volatilities of options differ systematically over the "moneyness" of the option. This pattern of implied volatilities across exercise prices is known as the "volatility smile" or "volatility skew." Studies such as "Implied Volatility" by Stewart Mayhew, Financial Analysts Journal, July-August 1995, have found that implied volatilities based on near-the-money options do as well as sophisticated weighted implied volatilities in estimating expected volatility. In addition, the staff believes that because near-the-money options are generally more actively traded, they may provide a better basis for deriving implied volatility.

[48] The staff believes a company could use a weighted-average implied volatility based on traded options that are either in-the-money or out-of-the-money. For example, if the employee share option has an exercise price of $52, but the only traded options available have exercise prices of $50 and

Continued

4. Similarity of Length of Terms—

The staff believes that when valuing an employee share option with a given expected or contractual term, as applicable, the implied volatility derived from a traded option with a similar term would be the most relevant. However, if there are no traded options with maturities that are similar to the share option's contractual or expected term, as applicable, then the staff believes Company B could consider traded options with a remaining maturity of six months or greater.[49] However, when using traded options with a term of less than one year,[50] the staff would expect the company to also consider other relevant information in estimating expected volatility. In general, the staff believes more reliance on the implied volatility derived from a traded option would be expected the closer the remaining term of the traded option is to the expected or contractual term, as applicable, of the employee share option.

The staff believes Company B's evaluation of the factors above should assist in determining whether the implied volatility appropriately reflects the market's expectations of future volatility and thus the extent of reliance that Company B reasonably places on the implied volatility.

Question 4: Are there situations in which it is acceptable for Company B to rely exclusively on either implied volatility or historical volatility in its estimate of expected volatility?

Interpretive Response: As stated above, FASB ASC Topic 718 does not specify a method of estimating expected volatility; rather, it provides a list of factors that should be considered and requires that an entity's estimate of expected volatility be reasonable and supportable.[51] Many of the factors listed in FASB ASC Topic 718 are discussed in Questions 2 and 3 above. The objective of estimating volatility, as stated in FASB ASC Topic 718, is to ascertain the assumption about expected volatility that marketplace participants would likely use in determining a price for an option.[52] The staff believes that a company, after considering the factors listed in FASB ASC Topic 718, could, in certain situations, reasonably conclude that exclusive reliance on either historical or implied volatility would provide an estimate of expected volatility that meets this stated objective.

The staff would not object to Company B placing exclusive reliance on implied volatility when the following factors are present, as long as the methodology is consistently applied:

- Company B utilizes a valuation model that is based upon a constant volatility assumption to value its employee share options;[53]
- The implied volatility is derived from options that are actively traded;
- The market prices (trades or quotes) of both the traded options and underlying shares are measured at a similar point in time to each other and on a date reasonably close to the grant date of the employee share options;
- The traded options have exercise prices that are both (a) near-the-money and (b) close to the exercise price of the employee share options; [54] and
- The remaining maturities of the traded options on which the estimate is based are at least one year.

The staff would not object to Company B placing exclusive reliance on historical volatility when the following factors are present, so long as the methodology is consistently applied:

- Company B has no reason to believe that its future volatility over the expected or contractual term, as applicable, is likely to differ from its past; [55]
- The computation of historical volatility uses a simple average calculation method;
- A sequential period of historical data at least equal to the expected or contractual term of the share option, as applicable, is used; and
- A reasonably sufficient number of price observations are used, measured at a consistent point throughout the applicable historical period.[56]

Question 5: What disclosures would the staff expect Company B to include in its financial statements and MD&A regarding its assumption of expected volatility?

Interpretive Response: FASB ASC paragraph 718–10–50–2 prescribes the minimum information needed to achieve the Topic's disclosure objectives.[57] Under that guidance, Company B is required to disclose the expected volatility and the method used to estimate it.[58] Accordingly, the staff expects that at a minimum Company B would disclose in a footnote to its financial statements how it determined the expected volatility assumption for purposes of determining the fair value of its share options in accordance with FASB ASC Topic 718. For example, at a minimum, the staff would expect Company B to disclose whether it used only implied volatility, historical volatility, or a combination of both.

In addition, Company B should consider the applicability of SEC Release No. FR–60 and Section V, "Critical Accounting Estimates," in SEC Release No. FR–72 regarding critical accounting policies and estimates in MD&A. The staff would expect such disclosures to include an explanation of the method used to estimate the expected volatility of its share price. This explanation generally should include a discussion of the basis for the company's conclusions regarding the extent to which it used historical volatility, implied volatility or a combination of both. A company could consider summarizing its evaluation of the factors listed in Questions 2 and 3 of this section as part of these disclosures in MD&A.

Facts: Company C is a newly public entity with limited historical data on the

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$55, then the staff believes that it is appropriate to use a weighted average based on the implied volatilities from the two traded options; for this example, a 40% weight on the implied volatility calculated from the option with an exercise price of $55 and a 60% weight on the option with an exercise price of $50.

[49] The staff believes it may also be appropriate to consider the entire term structure of volatility provided by traded options with a variety of remaining maturities. If a company considers the entire term structure in deriving implied volatility, the staff would expect a company to include some options in the term structure with a remaining maturity of six months or greater.

[50] The staff believes the implied volatility derived from a traded option with a term of one year or greater would typically not be significantly different from the implied volatility that would be derived from a traded option with a significantly longer term.

[51] FASB ASC paragraphs 718–10–55–36 through 718–10–55–37.

[52] FASB ASC paragraph 718–10–55–35.

[53] FASB ASC paragraphs 718–10–55–18 and 718–10–55–39 discuss the incorporation of a range of expected volatilities into option pricing models. The staff believes that a company that utilizes an option pricing model that incorporates a range of expected volatilities over the option's contractual term should consider the factors listed in FASB ASC Topic 718, and those discussed in the Interpretive Responses to Questions 2 and 3 above, to determine the extent of its reliance (including exclusive reliance) on the derived implied volatility.

[54] When near-the-money options are not available, the staff believes the use of a weighted-average approach, as noted in a previous footnote, may be appropriate.

[55] *See* FASB ASC paragraph 718–10–55–38. A change in a company's business model that results in a material alteration to the company's risk profile is an example of a circumstance in which the company's future volatility would be expected to differ from its past volatility. Other examples may include, but are not limited to, the introduction of a new product that is central to a company's business model or the receipt of U.S. Food and Drug Administration approval for the sale of a new prescription drug.

[56] If the expected or contractual term, as applicable, of the employee share option is less than three years, the staff believes monthly price observations would not provide a sufficient amount of data.

[57] FASB ASC Section 718–10–50.

[58] FASB ASC subparagraph 718–10–50–2(f) (2) (ii).

price of its publicly traded shares and no other traded financial instruments. Company C believes that it does not have sufficient company specific information regarding the volatility of its share price on which to base an estimate of expected volatility.

Question 6: What other sources of information should Company C consider in order to estimate the expected volatility of its share price?

Interpretive Response: FASB ASC Topic 718 provides guidance on estimating expected volatility for newly public and nonpublic entities that do not have company specific historical or implied volatility information available.[59] Company C may base its estimate of expected volatility on the historical, expected or implied volatility of similar entities whose share or option prices are publicly available. In making its determination as to similarity, Company C would likely consider the industry, stage of life cycle, size and financial leverage of such other entities.[60]

The staff would not object to Company C looking to an industry sector index (*e.g.,* NASDAQ Computer Index) that is representative of Company C's industry, and possibly its size, to identify one or more similar entities.[61] Once Company C has identified similar entities, it would substitute a measure of the individual volatilities of the similar entities for the expected volatility of its share price as an assumption in its valuation model.[62] Because of the effects of diversification that are present in an industry sector index, Company C should not substitute the volatility of an index for the expected volatility of its share price as an assumption in its valuation model.[63]

After similar entities have been identified, Company C should continue to consider the volatilities of those entities unless circumstances change such that the identified entities are no longer similar to Company C. Until Company C has sufficient information available, the staff would not object to Company C basing its estimate of expected volatility on the volatility of similar entities for those periods for which it does not have sufficient information available.[64] Until Company C has either a sufficient amount of historical information regarding the volatility of its share price or other traded financial instruments are available to derive an implied volatility to support an estimate of expected volatility, it should consistently apply a process as described above to estimate expected volatility based on the volatilities of similar entities.[65]

2. Expected Term

FASB ASC paragraph 718–10–55–29 states "The fair value of a traded (or transferable) share option is based on its contractual term because rarely is it economically advantageous to exercise, rather than sell, a transferable share option before the end of its contractual term. Employee share options generally differ from transferable [or tradable] share options in that employees cannot sell (or hedge) their share options—they can only exercise them; because of this, employees generally exercise their options before the end of the options' contractual term. Thus, the inability to sell or hedge an employee share option effectively reduces the option's value [compared to a transferable option] because exercise prior to the option's expiration terminates its remaining life and thus its remaining time value." Accordingly, FASB ASC Topic 718 requires that when valuing an employee share option under the Black-Scholes-Merton framework the fair value of employee share options be based on the share options' expected term rather than the contractual term.

The staff believes the estimate of expected term should be based on the facts and circumstances available in each particular case. Consistent with our guidance regarding reasonableness immediately preceding Topic 14.A, the fact that other possible estimates are later determined to have more accurately reflected the term does not necessarily mean that the particular choice was unreasonable. The staff reminds registrants of the expected term disclosure requirements described in FASB ASC subparagraph 718–10–50–2(f)(2)(i).

Facts: Company D utilizes the Black-Scholes-Merton closed-form model to value its share options for the purposes of determining the fair value of the options under FASB ASC Topic 718. Company D recently granted share options to its employees. Based on its review of various factors, Company D determines that the expected term of the options is six years, which is less than the contractual term of ten years.

Question 1: When determining the fair value of the share options in accordance with FASB ASC Topic 718, should Company D consider an additional discount for nonhedgability and nontransferability?

Interpretive Response: No. FASB ASC paragraph 718–10–55–29 indicates that nonhedgability and nontransferability have the effect of increasing the likelihood that an employee share option will be exercised before the end of its contractual term. Nonhedgability and nontransferability therefore factor into the expected term assumption (in this case reducing the term assumption from ten years to six years), and the expected term reasonably adjusts for the effect of these factors. Accordingly, the staff believes that no additional reduction in the term assumption or other discount to the estimated fair value is appropriate for these particular factors.[66]

Question 2: Should forfeitures or terms that stem from forfeitability be factored into the determination of expected term?

Interpretive Response: No. FASB ASC Topic 718 indicates that the expected term that is utilized as an assumption in a closed-form option-pricing model or a resulting output of a lattice option pricing model when determining the fair value of the share options should not incorporate restrictions or other terms that stem from the pre-vesting forfeitability of the instruments. Under FASB ASC Topic 718, these pre-vesting restrictions or other terms are taken into account by ultimately recognizing compensation cost only for awards for

[59] FASB ASC paragraphs 718–10–55–25 and 718–10–55–51.

[60] FASB ASC paragraph 718–1055–25.

[61] If a company operates in a number of different industries, it could look to several industry indices. However, when considering the volatilities of multiple companies, each operating only in a single industry, the staff believes a company should take into account its own leverage, the leverages of each of the entities, and the correlation of the entities' stock returns.

[62] FASB ASC paragraph 718–10–55–51.

[63] FASB ASC paragraph 718–10–55–25.

[64] FASB ASC paragraph 718–10–55–37. The staff believes that at least two years of daily or weekly historical data could provide a reasonable basis on which to base an estimate of expected volatility if a company has no reason to believe that its future volatility will differ materially during the expected or contractual term, as applicable, from the volatility calculated from this past information. If the expected or contractual term, as applicable, of a share option is shorter than two years, the staff believes a company should use daily or weekly historical data for at least the length of that applicable term.

[65] FASB ASC paragraph 718–10–55–40.

[66] The staff notes the existence of academic literature that supports the assertion that the Black-Scholes-Merton closed-form model, with expected term as an input, can produce reasonable estimates of fair value. Such literature includes J. Carpenter, "The exercise and valuation of executive stock options," Journal of Financial Economics, May 1998, pp.127–158; C. Marquardt, "The Cost of Employee Stock Option Grants: An Empirical Analysis," Journal of Accounting Research, September 2002, p. 1191–1217); and J. Bettis, J. Bizjak and M. Lemmon, "Exercise behavior, valuation, and the incentive effect of employee stock options," Journal of Financial Economics, forthcoming, 2005.

which employees render the requisite service.[67]

Question 3: Can a company's estimate of expected term ever be shorter than the vesting period?

Interpretive Response: No. The vesting period forms the lower bound of the estimate of expected term.[68]

Question 4: FASB ASC paragraph 718–10–55–34 indicates that an entity shall aggregate individual awards into relatively homogenous groups with respect to exercise and post-vesting employment termination behaviors for the purpose of determining expected term, regardless of the valuation technique or model used to estimate the fair value. How many groupings are typically considered sufficient?

Interpretive Response: As it relates to employee groupings, the staff believes that an entity may generally make a reasonable fair value estimate with as few as one or two groupings.[69]

Question 5: What approaches could a company use to estimate the expected term of its employee share options?

Interpretive Response: A company should use an approach that is reasonable and supportable under FASB ASC Topic 718's fair value measurement objective, which establishes that assumptions and measurement techniques should be consistent with those that marketplace participants would be likely to use in determining an exchange price for the share options.[70] If, in developing its estimate of expected term, a company determines that its historical share option exercise experience is the best estimate of future exercise patterns, the staff will not object to the use of the historical share option exercise experience to estimate expected term.[71]

A company may also conclude that its historical share option exercise experience does not provide a reasonable basis upon which to estimate expected term. This may be the case for a variety of reasons, including, but not limited to, the life of the company and its relative stage of development, past or expected structural changes in the business, differences in terms of past equity-based share option grants,[72] or a lack of variety of price paths that the company may have experienced.[73]

FASB ASC Topic 718 describes other alternative sources of information that might be used in those cases when a company determines that its historical share option exercise experience does not provide a reasonable basis upon which to estimate expected term. For example, a lattice model (which by definition incorporates multiple price paths) can be used to estimate expected term as an input into a Black-Scholes-Merton closed-form model.[74] In addition, FASB ASC paragraph 718–10–55–32 states "* * * expected term might be estimated in some other manner, taking into account whatever relevant and supportable information is available, including industry averages and other pertinent evidence such as published academic research." For example, data about exercise patterns of employees in similar industries and/or situations as the company's might be used. While such comparative information may not be widely available at present, the staff understands that various parties, including actuaries, valuation professionals and others are gathering such data.

Facts: Company E grants equity share options to its employees that have the following basic characteristics:[75]

- The share options are granted at-the-money;
- Exercisability is conditional only on performing service through the vesting date;[76]
- If an employee terminates service prior to vesting, the employee would forfeit the share options;
- If an employee terminates service after vesting, the employee would have a limited time to exercise the share options (typically 30–90 days); and
- The share options are nontransferable and nonhedgeable.

Company E utilizes the Black-Scholes-Merton closed-form model for valuing its employee share options.

Question 6: As share options with these "plain vanilla" characteristics have been granted in significant quantities by many companies in the past, is the staff aware of any "simple" methodologies that can be used to estimate expected term?

Interpretive Response: As noted above, the staff understands that an entity that is unable to rely on its historical exercise data may find that certain alternative information, such as exercise data relating to employees of other companies, is not easily obtainable. As such, some companies may encounter difficulties in making a refined estimate of expected term. Accordingly, if a company concludes that its historical share option exercise experience does not provide a reasonable basis upon which to estimate expected term, the staff will accept the following "simplified" method for "plain vanilla" options consistent with those in the fact set above: expected term = ((vesting term + original contractual term)/2). Assuming a ten year original contractual term and graded vesting over four years (25% of the options in each grant vest annually) for the share options in the fact set described above, the resultant expected term would be 6.25 years.[77] Academic research on the exercise of options issued to executives provides some general support for outcomes that would be produced by the application of this method.[78]

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[67] FASB ASC paragraph 718–10–30–11.

[68] FASB ASC paragraph 718–10–55–31.

[69] The staff believes the focus should be on groups of employees with significantly different expected exercise behavior. Academic research suggests two such groups might be executives and non-executives. A study by S. Huddart found executives and other senior managers to be significantly more patient in their exercise behavior than more junior employees. (Employee rank was proxied for by the number of options issued to that employee.) *See* S. Huddart, "Patterns of stock option exercise in the United States," in: J. Carpenter and D. Yermack, eds., Executive Compensation and Shareholder Value: Theory and Evidence (Kluwer, Boston, MA, 1999), pp. 115–142. *See also* S. Huddart and M. Lang, "Employee stock option exercises: An empirical analysis," Journal of Accounting and Economics, 1996, pp. 5–43.

[70] FASB ASC paragraph 718–10–55–13.

[71] Historical share option exercise experience encompasses data related to share option exercise, post-vesting termination, and share option contractual term expiration.

[72] For example, if a company had historically granted share options that were always in-the-money, and will grant at-the-money options prospectively, the exercise behavior related to the in-the-money options may not be sufficient as the sole basis to form the estimate of expected term for the at-the-money grants.

[73] For example, if a company had a history of previous equity-based share option grants and exercises only in periods in which the company's share price was rising, the exercise behavior related to those options may not be sufficient as the sole basis to form the estimate of expected term for current option grants.

[74] FASB ASC paragraph 718–10–55–30.

[75] Employee share options with these features are sometimes referred to as "plain vanilla" options.

[76] In this fact pattern the requisite service period equals the vesting period.

[77] Calculated as [[[1 year vesting term (for the first 25% vested) plus 2 year vesting term (for the second 25% vested) plus 3 year vesting term (for the third 25% vested) plus 4 year vesting term (for the last 25% vested)] divided by 4 total years of vesting] plus 10 year contractual life] divided by 2; that is, (((1+2+3+4)/4) + 10)/2 = 6.25 years.

[78] J.N. Carpenter, "The exercise and valuation of executive stock options," Journal of Financial Economics, 1998, pp.127–158 studies a sample of 40 NYSE and AMEX firms over the period 1979–1994 with share option terms reasonably consistent to the terms presented in the fact set and example. The mean time to exercise after grant was 5.83 years and the median was 6.08 years. The "mean time to exercise" is shorter than expected term since the study's sample included only exercised options. Other research on executive options includes (but is not limited to) J. Carr Bettis; John M. Bizjak; and Michael L. Lemmon, "Exercise behavior, valuation, and the incentive effects of employee stock options," forthcoming in the Journal of Financial Economics. One of the few studies on nonexecutive employee options the staff is aware of is S. Huddart, "Patterns of stock option exercise in the United States," in: J. Carpenter and D. Yermack, eds., Executive Compensation and Shareholder Value: Theory and Evidence (Kluwer, Boston, MA, 1999), pp. 115–142.

Examples of situations in which the staff believes that it may be appropriate to use this simplified method include the following:

• A company does not have sufficient historical exercise data to provide a reasonable basis upon which to estimate expected term due to the limited period of time its equity shares have been publicly traded.

• A company significantly changes the terms of its share option grants or the types of employees that receive share option grants such that its historical exercise data may no longer provide a reasonable basis upon which to estimate expected term.

• A company has or expects to have significant structural changes in its business such that its historical exercise data may no longer provide a reasonable basis upon which to estimate expected term.

The staff understands that a company may have sufficient historical exercise data for some of its share option grants but not for others. In such cases, the staff will accept the use of the simplified method for only some but not all share option grants. The staff also does not believe that it is necessary for a company to consider using a lattice model before it decides that it is eligible to use this simplified method. Further, the staff will not object to the use of this simplified method in periods prior to the time a company's equity shares are traded in a public market.

If a company uses this simplified method, the company should disclose in the notes to its financial statements the use of the method, the reason why the method was used, the types of share option grants for which the method was used if the method was not used for all share option grants, and the periods for which the method was used if the method was not used in all periods. Companies that have sufficient historical share option exercise experience upon which to estimate expected term may not apply this simplified method. In addition, this simplified method is not intended to be applied as a benchmark in evaluating the appropriateness of more refined estimates of expected term.

Also, as noted above in Question 5, the staff believes that more detailed external information about exercise behavior will, over time, become readily available to companies. As such, the staff does not expect that such a simplified method would be used for share option grants when more relevant detailed information becomes widely available.

E. FASB ASC Topic 718, Compensation—Stock Compensation, and Certain Redeemable Financial Instruments

Certain financial instruments awarded in conjunction with share-based payment arrangements have redemption features that require settlement by cash or other assets upon the occurrence of events that are outside the control of the issuer.[79] FASB ASC Topic 718 provides guidance for determining whether instruments granted in conjunction with share-based payment arrangements should be classified as liability or equity instruments. Under that guidance, most instruments with redemption features that are outside the control of the issuer are required to be classified as liabilities; however, some redeemable instruments will qualify for equity classification.[80] SEC Accounting Series Release No. 268, Presentation in Financial Statements of "Redeemable Preferred Stocks," [81] ("ASR 268") and related guidance [82] address the classification and measurement of certain redeemable equity instruments.

Facts: Under a share-based payment arrangement, Company F grants to an employee shares (or share options) that all vest at the end of four years (cliff vest). The shares (or shares underlying the share options) are redeemable for cash at fair value at the holder's option, but only after six months from the date of share issuance (as defined in FASB ASC Topic 718). Company F has determined that the shares (or share options) would be classified as equity instruments under the guidance of FASB ASC Topic 718. However, under ASR 268 and related guidance, the instruments would be considered to be redeemable for cash or other assets upon the occurrence of events (*e.g.,* redemption at the option of the holder) that are outside the control of the issuer.

Question 1: While the instruments are subject to FASB ASC Topic 718,[83] is ASR 268 and related guidance applicable to instruments issued under share-based payment arrangements that are classified as equity instruments under FASB ASC Topic 718?

Interpretive Response: Yes. The staff believes that registrants must evaluate whether the terms of instruments granted in conjunction with share-based payment arrangements with employees that are not classified as liabilities under FASB ASC Topic 718 result in the need to present certain amounts outside of permanent equity (also referred to as being presented in "temporary equity") in accordance with ASR 268 and related guidance.[84]

When an instrument ceases to be subject to FASB ASC Topic 718 and becomes subject to the recognition and measurement requirements of other applicable GAAP, the staff believes that the company should reassess the classification of the instrument as a liability or equity at that time and consequently may need to reconsider the applicability of ASR 268.

Question 2: How should Company F apply ASR 268 and related guidance to the shares (or share options) granted under the share-based payment arrangements with employees that may be unvested at the date of grant?

Interpretive Response: Under FASB ASC Topic 718, when compensation cost is recognized for instruments classified as equity instruments, additional paid-in-capital [85] is increased. If the award is not fully vested at the grant date, compensation cost is recognized and additional paid-in-capital is increased over time as services are rendered over the requisite

[79] The terminology "outside the control of the issuer" is used to refer to any of the three redemption conditions described in Rule 5–02.28 of Regulation S–X that would require classification outside permanent equity. That rule requires preferred securities that are redeemable for cash or other assets to be classified outside of permanent equity if they are redeemable (1) at a fixed or determinable price on a fixed or determinable date, (2) at the option of the holder, or (3) upon the occurrence of an event that is not solely within the control of the issuer.

[80] FASB ASC paragraphs 718–10–25–6 through 718–10–25–19.

[81] ASR 268, July 27, 1979, Rule 5–02.28 of Regulation S–X.

[82] Related guidance includes FASB ASC paragraph 480–10–S99–3 (Distinguishing Liabilities from Equity Topic).

[83] FASB ASC paragraph 718–10–35–13 states that an instrument ceases to be subject to this Topic when "the rights conveyed by the instrument to the holder are no longer dependent on the holder being an employee of the entity (that is, no longer dependent on providing service)."

[84] Instruments granted in conjunction with share-based payment arrangements with employees that do not by their terms require redemption for cash or other assets (at a fixed or determinable price on a fixed or determinable date, at the option of the holder, or upon the occurrence of an event that is not solely within the control of the issuer) would not be assumed by the staff to require net cash settlement for purposes of applying ASR 268 in circumstances in which FASB ASC Section 815–40–25, Derivatives and Hedging—Contracts in Entity's Own Equity—Recognition, would otherwise require the assumption of net cash settlement. *See* FASB ASC paragraph 815–40–25–11, which states, in part: "* * * the events or actions necessary to deliver registered shares are not controlled by an entity and, therefore, except under the circumstances described in FASB ASC paragraph 815–40–25–16, if the contract permits the entity to net share or physically settle the contract only by delivering registered shares, it is assumed that the entity will be required to net cash settle the contract." *See also* FASB ASC subparagraph 718–10–25–15(a).

[85] Depending on the fact pattern, this may be recorded as common stock and additional paid in capital.

service period. A similar pattern of recognition should be used to reflect the amount presented as temporary equity for share-based payment awards that have redemption features that are outside the issuer's control but are classified as equity instruments under FASB ASC Topic 718. The staff believes Company F should present as temporary equity at each balance sheet date an amount that is based on the redemption amount of the instrument, but takes into account the proportion of consideration received in the form of employee services. Thus, for example, if a nonvested share that qualifies for equity classification under FASB ASC Topic 718 is redeemable at fair value more than six months after vesting, and that nonvested share is 75% vested at the balance sheet date, an amount equal to 75% of the fair value of the share should be presented as temporary equity at that date. Similarly, if an option on a share of redeemable stock that qualifies for equity classification under FASB ASC Topic 718 is 75% vested at the balance sheet date, an amount equal to 75% of the intrinsic [86] value of the option should be presented as temporary equity at that date.

Question 3: Would the methodology described for employee awards in the Interpretive Response to Question 2 above apply to nonemployee awards to be issued in exchange for goods or services with similar terms to those described above?

Interpretive Response: See Topic 14.A for a discussion of the application of the principles in FASB ASC Topic 718 to nonemployee awards. The staff believes it would generally be appropriate to apply the methodology described in the Interpretive Response to Question 2 above to nonemployee awards.

F. Classification of Compensation Expense Associated with Share-Based Payment Arrangements

Facts: Company G utilizes both cash and share-based payment arrangements to compensate its employees and nonemployee service providers. Company G would like to emphasize in its income statement the amount of its compensation that did not involve a cash outlay.

Question: How should Company G present in its income statement the non-cash nature of its expense related to share-based payment arrangements?

Interpretive Response: The staff believes Company G should present the expense related to share-based payment arrangements in the same line or lines as cash compensation paid to the same employees.[87] The staff believes a company could consider disclosing the amount of expense related to share-based payment arrangements included in specific line items in the financial statements. Disclosure of this information might be appropriate in a parenthetical note to the appropriate income statement line items, on the cash flow statement, in the footnotes to the financial statements, or within MD&A.

G. Removed by SAB 114 [88,89]

H. Removed by SAB 114 [90,91,92,93]

I. Capitalization of Compensation Cost Related to Share-Based Payment Arrangements

Facts: Company K is a manufacturing company that grants share options to its production employees. Company K has determined that the cost of the production employees' service is an inventoriable cost. As such, Company K is required to initially capitalize the cost of the share option grants to these production employees as inventory and later recognize the cost in the income statement when the inventory is consumed.[94]

Question: If Company K elects to adjust its period end inventory balance for the allocable amount of share-option cost through a period end adjustment to its financial statements, instead of incorporating the share-option cost through its inventory costing system, would this be considered a deficiency in internal controls?

[86] The potential redemption amount of the share option in this illustration is its intrinsic value because the holder would pay the exercise price upon exercise of the option and then, upon redemption of the underlying shares, the company would pay the holder the fair value of those shares. Thus, the net cash outflow from the arrangement would be equal to the intrinsic value of the share option. In situations where there would be no cash inflows from the share option holder, the cash required to be paid to redeem the underlying shares upon the exercise of the put option would be the redemption value.

[87] FASB ASC Topic 718 does not identify a specific line item in the income statement for presentation of the expense related to share-based payment arrangements.

[88] [Original footnote removed by SAB 114.]

[89] [Original footnote removed by SAB 114.]

[90] [Original footnote removed by SAB 114.]

[91] [Original footnote removed by SAB 114.]

[92] [Original footnote removed by SAB 114.]

[93] [Original footnote removed by SAB 114.]

[94] FASB ASC paragraph 718–10–25–2.

Interpretive Response: No. FASB ASC Topic 718, Compensation—Stock Compensation, does not prescribe the mechanism a company should use to incorporate a portion of share-option costs in an inventory-costing system. The staff believes Company K may accomplish this through a period end adjustment to its financial statements. Company K should establish appropriate controls surrounding the calculation and recording of this period end adjustment, as it would any other period end adjustment. The fact that the entry is recorded as a period end adjustment, by itself, should not impact management's ability to determine that the internal control over financial reporting, as defined by the SEC's rules implementing Section 404 of the Sarbanes-Oxley Act of 2002,[95] is effective.

J. Removed by SAB 114 [96] [97] [98]

[95] Release No. 34–47986, June 5, 2003, Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Period Reports.

[96] [Original footnote removed by SAB 114.]

[97] [Original footnote removed by SAB 114.]

[98] [Original footnote removed by SAB 114.]

K. Removed by SAB 114 [99] [100] [101] [102] [103]

L. Removed by SAB 114 [104] [105] [106]

M. Removed by SAB 114

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[99] [Original footnote removed by SAB 114.]

[100] [Original footnote removed by SAB 114.]

[101] [Original footnote removed by SAB 114.]

[102] [Original footnote removed by SAB 114.]

[103] [Original footnote removed by SAB 114.]

[104] [Original footnote removed by SAB 114.]

[105] [Original footnote removed by SAB 114.]

[106] [Original footnote removed by SAB 114.]