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. 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.

**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 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
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. 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) are audited only for the two latest fiscal years. 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 are set forth in the Acquisition, Development, and Construction Arrangements (ADC Arrangements) Subsection of FASB ASC Subtopic 310-10, Receivables - Overall. In September 1986 the EITF reached a consensus on this issue 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.

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. 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) 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.

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

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. 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 textual 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 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:

- the combined significance of businesses acquired or to be acquired for which 
  (a) audited financial statements cover a period of less than 9 months\(^ {21}\) may not exceed 10%;
  - the combined significance of businesses acquired or to be acquired for which 
    (b) audited financial statements cover a period of less than 21 months may not exceed 20%; and
  - the combined significance of businesses acquired or to be acquired for which 
    (c) 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:

<table>
<thead>
<tr>
<th>Acquiree</th>
<th>Fiscal Year End</th>
<th>Date of Acquisition</th>
<th>Highest Significance at Acquisition</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>3/31</td>
<td>1/1/x7</td>
<td>60%</td>
</tr>
<tr>
<td>B</td>
<td>7/31</td>
<td>4/1/x7</td>
<td>45%</td>
</tr>
<tr>
<td>C</td>
<td>9/30</td>
<td>9/1/x7</td>
<td>40%</td>
</tr>
<tr>
<td>D</td>
<td>12/31</td>
<td>2/1/x8</td>
<td>21%</td>
</tr>
<tr>
<td>E</td>
<td>3/31</td>
<td>11/1/x8</td>
<td>11%</td>
</tr>
<tr>
<td>F</td>
<td>12/31</td>
<td>To be acquired</td>
<td>11%</td>
</tr>
</tbody>
</table>

The following table reflects the application of the significance tests to the combined financial information at the time the registration statement is filed.

| Significance of |
|-----------------|-----------------|-----------------|-----------------|-----------------|
| Component       | Entity          | Assets          | Earnings         | Investment      |

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### Topic 1: Financial Statements

<table>
<thead>
<tr>
<th>Component Entity</th>
<th>Date of Acquisition</th>
<th>Minimum Financial Statement Requirement</th>
<th>Period in Consolidated Financial Statements</th>
<th>Separate Pre-acquisition Audited Financial Statement (months)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Registrant</td>
<td>N/A</td>
<td>33</td>
<td>36</td>
<td></td>
</tr>
<tr>
<td>A</td>
<td>1/1/x7</td>
<td>33</td>
<td>24</td>
<td>9</td>
</tr>
<tr>
<td>B</td>
<td>4/1/x7</td>
<td>33</td>
<td>21</td>
<td>12 23</td>
</tr>
</tbody>
</table>

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 tests.

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

**K. Financial Statements Of Acquired Troubled Financial Institutions**

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

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

A number of registrants have acquired, or are contemplating acquisition of, these troubled financial institutions. Complete audited financial statements of the institutions for the periods necessary to comply fully with Rule 3-05 of Regulation S-X may not be reasonably available in some cases. Some troubled institutions have never obtained an audit while others have been operated under receivership by regulators for a significant period without audit. Auditors’ reports on the financial statements of some of these acquirees may not satisfy the requirements of Rule 2-02 of Regulation S-X because they contain qualifications due to audit scope limitations or disclaim an opinion.

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

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

**Interpretive Response:** Yes. In some case, financial statements will not be required because there is not sufficient continuity of the acquired entity's operations prior to and after the acquisition, so that disclosure of prior financial information is material to an understanding of future operations, as discussed in Rule 11-01 of Regulation S-X. For example, such a circumstance may exist in the case of an acquisition solely of the physical facilities of a banking branch with assumption of the related deposits if neither income-producing assets (other than treasury bills and similar low-risk investment) nor the management responsible for its historical investment and lending activities transfer with the branch to the registrant. In this and other circumstances, where the registrant can persuasively demonstrate that continuity of operations is substantially lacking and a representation to this effect is included in the filing, the staff will not object to the omission of financial statements. However, applicable disclosures specified by Industry Guide 3, Article 11 of Regulation S-X (pro forma information), and other information which is descriptive of the transaction and
of the assets acquired and liabilities assumed should be furnished to the extent reasonably available.

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

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

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 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, registrants must comply with Sections 13(b)(2) - (7) of the Securities Exchange Act of 1934 (the "Exchange Act"). Under these provisions, each registrant with securities registered pursuant to section 12 of the Exchange Act, or required to file reports pursuant to Section 15(d), 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. 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. 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 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. 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.

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."
- 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. 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." 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 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 ..." 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. The clear implication of SAS 99 is that immaterial misstatements may be fraudulent financial reporting.

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.

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. 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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{72}

General comments

This SAB is not intended to change current law or guidance in the accounting or auditing literature.\textsuperscript{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, 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.\textsuperscript{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.\textsuperscript{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). 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.

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 $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\(^7\) 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.

[Revised in *Staff Accounting Bulletin No. 114*, effective March 28, 2011, 76 F.R. 17192.]

Footnotes

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."

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.

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.
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.

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."

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.

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.

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.

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."

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.

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.

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.

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.

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 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.


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.


31 Concepts Statement 2, paragraphs 131 and 166.
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.

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).

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.

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.

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).

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

AU 9326.33.

Id.

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.

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).

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.


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).


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.


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."

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.

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.

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.
Codification of Staff Accounting Bulletin Topic

Codification of Staff Accounting Bulletin Topic 2

http://52.71.186.76/document/read/G82-IDAL1LQ-G82-IDAXMRR

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 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. ́
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. 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.

**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. **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.
   - 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.
3. 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.
   - 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.
4. 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.

[Revised in Staff Accounting Bulletin No. 114, effective March 28, 2011, 76 F.R. 17192.]

E. Removed by SAB 103
F. Removed by SAB 103

Footnotes

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.


3 As announced in Financial Reporting Release No. 2 (July 9, 1982).
Codification of Staff Accounting Bulletin Topic

Codification of Staff Accounting Bulletin Topic 3

http://52.71.186.76/document/read/G82-IDAL1LQ-G82-IDAKWRR

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 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.

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Codification of Staff Accounting Bulletin Topic

Codification of Staff Accounting Bulletin Topic 4

http://52.71.186.76/document/read/G82-IDAL1LQ-G82-IDAPZRR

**Topic 4: Equity Accounts**

A. Subordinated Debt

*Facts:* Company E proposes to include in its registration statement a balance sheet showing its subordinated 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 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 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 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 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 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. 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.

[Revised in Staff Accounting Bulletin No. 114, effective March 28, 2011, 76 F.R. 17192.]

**Footnotes**

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."
As prescribed by FASB ASC Topic 718, Compensation - Stock Compensation.
Codification of Staff Accounting Bulletin Topic

Codification of Staff Accounting Bulletin Topic 5

http://52.71.186.76/document/read/G82-IDAL1LQ-G82-IDAZASR

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.

C.

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 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. 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, 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. 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. 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 or stock, etc. that provides security for Company A's debt; (3) the extent (in the aggregate and for each of the five years subsequent to the date of the latest balance sheet presented) to which Company A is dependent on Company B's cash flows to service its debt and the method by which this will occur; and (4) the impact of such cash flows on Company B's ability to pay dividends or other amounts to holders of its securities. Additionally, the staff believes Company B's Management's Discussion and Analysis of Financial Condition and Results of Operations should discuss any material impact of its servicing of Company A's debt on its own liquidity pursuant to Item 303(a)(1) of Regulation S-K.
K. 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. 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. 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 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 insurance contracts for purposes of reporting to state regulatory authorities, using discount rates permitted or prescribed by those authorities (“statutory rates”) which approximate 3 1/2 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. 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. Additionally, since the charges are not both unusual and infrequent 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. 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
  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
  (2) 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 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 (either as a result of expenditures or changes in reversals of estimates or the fair value of the liability) should be disclosed in the footnotes to the interim and annual financial statements and discussed in MD&A. In the event a company recognized liabilities for exit costs and involuntary employee termination benefits relating to multiple exit plans, the staff believes presentation of separate information for each individual exit plan that has a material effect on the balance sheet, results of operations or cash flows generally is appropriate.

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

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

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

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

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

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

Question 2: Is it acceptable to recognize the dividend costs of increasing rate preferred stocks according to their stated dividend schedules?
Interpretive Response: No. The staff believes that when consideration received for preferred stocks reflects expectations of future dividend streams, as is normally the case with cumulative preferred stocks, any discount due to an absence of dividends (as with Class A) or gradually increasing dividends (as with Class B) for an initial period represents prepaid, unstated dividend cost. Recognizing the dividend cost of these instruments according to their stated dividend schedules would report Class A as being cost-free, and would report the cost of Class B at less than its effective cost, from the standpoint of common stock interests (i.e., for purposes of computing income applicable to common stock and earnings per common share) during the years 20X1 through 20X3.

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

<table>
<thead>
<tr>
<th>Year</th>
<th>Beginning of Year (BOY)</th>
<th>Imputed Dividend (8% of Carrying Amount at BOY)</th>
<th>End of year</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X1</td>
<td>$79.38</td>
<td>6.35</td>
<td>85.73</td>
</tr>
<tr>
<td>20X2</td>
<td>85.73</td>
<td>6.86</td>
<td>92.59</td>
</tr>
<tr>
<td>20X3</td>
<td>92.59</td>
<td>7.41</td>
<td>100.00</td>
</tr>
</tbody>
</table>

During 20X4 and thereafter, the stated dividend of $8 measured against the carrying amount of $100 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 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. 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 accounting principles 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 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 for a quasi-reorganization are satisfied.

**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.

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. 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 are limited to offsetting adjustments to reflect decreases in other assets (or increases in liabilities) to reflect their new fair value. In other words, a quasi-reorganization should not result in a write-up of net assets of the registrant.

**Question 4:** The interpretive response to question 1 indicates that the staff believes that a deficit reclassification of any nature is considered to be a quasi-reorganization, and accordingly, must satisfy all the conditions of Section 210. 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-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 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 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. 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 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. 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, 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 over the fair value. Fair value is the amount that would be realizable in an outright sale to an unrelated third party for cash. The same concepts should be applied in determining fair value of the transferred assets, i.e., if an active market exists for the assets transferred, then fair value is equal to the market value. If no active market exists, but one exists for similar assets, the selling prices in that market may be helpful in estimating the fair value. If no such market price is available, a forecast of expected cash flows, discounted at a rate commensurate with the risks involved, may be used to aid in estimating the fair value. In situations where discounted cash flows are used to estimate fair value of nonperforming assets, the staff would expect that the interest rate used in such computations will be substantially higher than the cost of funds of the financial institution and appropriately reflect the risk of holding these nonperforming assets. Therefore, the fair value determined in such a way will be lower than the amount at which the assets would have been carried by the financial institution had the transfer not occurred, unless the financial institution had been required under GAAP to carry such assets at market value or the lower of cost or market value.

**Question 3**: Where the transaction may appropriately be accounted for as a sale to an unconsolidated party and the financial institution receives a note receivable or other redeemable instrument from the new entity,
how should such asset be disclosed pursuant to Item III C, “Risk Elements,” of Industry Guide 3? What factors should be considered related to the subsequent accounting for such instruments received?

Interpretive Response: The staff believes that the financial institution may exclude the note receivable or other asset from its Risk Elements disclosures under Guide 3 provided that: (a) the receivable itself does not constitute a nonaccrual, past due, restructured, or potential problem loan that would require disclosure under Guide 3, and (b) the underlying collateral is described in sufficient detail to enable investors to understand the nature of the note receivable or other asset, if material, including the extent of any over-collateralization. The description of the collateral normally would include material information similar to that which would be provided if such assets were owned by the financial institution, including pertinent Risk Element disclosures.

The staff notes that, in situations in which the transaction is accounted for as a sale to an unconsolidated party and a portion of the consideration received by the registrant is debt or another redeemable instrument, careful consideration must be given to the appropriateness of recording profits on the management fee 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.

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”). 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. 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, 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 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, 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 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 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?

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. 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.  

**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), 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), 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).

**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 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. 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 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, 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).

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.  

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 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, 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 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.

[Revised in Staff Accounting Bulletin No. 114, effective March 28, 2011, 76 F.R. 17192.]

Footnotes

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."

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.]

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.
See FASB ASC paragraph 225-20-45-2.

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.

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.

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.

"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.

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.

See Question 3 regarding variable increasing rate preferred stocks.

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.

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.

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

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.

ASR 25.

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."

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).

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.

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]
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.]

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.

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

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

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.


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

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.

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.

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

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.

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.
Item 303 of Regulation S-K.

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

See also disclosure requirement for inventory balances in Rule 5-02(6) of Regulation S-X.

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.