

# FINANCIAL ACCOUNTING SERIES



## ACCOUNTING STANDARDS UPDATE

No. 2012-03

August 2012

### Technical Amendments and Corrections to SEC Sections

Amendments to SEC Paragraphs Pursuant to SEC  
Staff Accounting Bulletin No. 114, Technical  
Amendments Pursuant to SEC Release No. 33-9250,  
and Corrections Related to FASB Accounting  
Standards Update 2010-22

An Amendment of the *FASB Accounting Standards Codification*®

Financial Accounting Standards Board  
of the Financial Accounting Foundation

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# Amendments to the *FASB Accounting Standards Codification*<sup>®</sup>

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## Securities and Exchange Commission (SEC) Content

### Section A: Amendments Pursuant to the Issuance of Staff Accounting Bulletin No. 114

*This Accounting Standards Update amends various SEC paragraphs pursuant to the issuance of Staff Accounting Bulletin No. 114.*

1. Amend paragraph 205-10-S99-8, with no link to a transition paragraph, as follows:

#### **Presentation of Financial Statements—Overall**

##### **SEC Materials**

##### **> SEC Staff Guidance**

##### **> > Staff Accounting Bulletins**

##### **> > > SAB Topic 6.K.2, Parent Company Financial Information**

**205-10-S99-8** The following is the text of SAB Topic 6.K.2, Parent Company Financial Information.

##### **a. Computation of restricted net assets of subsidiaries.**

Facts: The revised rules for parent company disclosures adopted in ASR 302 require, in certain circumstances, (1) footnote disclosure in the consolidated financial statements about the nature and amount of significant restrictions on the ability of subsidiaries to transfer funds to the parent through intercompany loans, advances or cash dividends [Rule 4-08(e)(3)], and (2) the presentation of condensed parent company financial information and other data in a schedule (Rule 12-04). To determine which disclosures, if any, are required, a registrant must compute its proportionate share of the net assets of its consolidated and unconsolidated subsidiary companies as of the end of the most recent fiscal year which are restricted as to transfer to the parent company because the consent of a third party (a lender, regulatory agency, foreign government, etc.) is required. If the registrant's proportionate share of the restricted net assets of consolidated subsidiaries exceeds 25% of the registrant's consolidated net assets, both the footnote and

schedule information are required. If the amount of such restrictions is less than 25%, but the sum of these restrictions plus the amount of the registrant's proportionate share of restricted net assets of unconsolidated subsidiaries plus the registrant's equity in the undistributed earnings of 50% or less owned persons (investees) accounted for by the equity method exceed 25% of consolidated net assets, the footnote disclosure is required.

Question 1: How are restricted net assets of subsidiaries computed?

Interpretative Response: The calculation of restricted net assets requires an evaluation of each subsidiary to identify any circumstances where third parties may limit the subsidiary's ability to loan, advance or dividend funds to the parent. This evaluation normally comprises a review of loan agreements, statutory and regulatory requirements, etc., to determine the dollar amount of each subsidiary's restrictions. The related amount of the subsidiary's net assets designated as restricted, however, should not exceed the amount of the subsidiary's net assets included in consolidated net assets, since parent company disclosures are triggered when a significant amount of consolidated net assets are restricted. The amount of each subsidiary's net assets included in consolidated net assets is determined by allocating (pushing down) to each subsidiary any related consolidation adjustments such as intercompany balances, intercompany profits, and differences between fair value and historical cost arising from a business combination accounted for as a purchase. This amount is referred to as the subsidiary's adjusted net assets. If the subsidiary's adjusted net assets are less than the amount of its restrictions because the push down of consolidating adjustments reduced its net assets, the subsidiary's adjusted net assets is the amount of the subsidiary's restricted net assets used in the tests.

Registrants with numerous subsidiaries and investees may wish to develop approaches to facilitate the determination of its parent company disclosure requirements. For example, if the parent company's adjusted net assets (excluding any interest in its subsidiaries) exceed 75% of consolidated net assets, or if the total of all of the registrant's consolidated and unconsolidated subsidiaries' restrictions and its equity in investees' earnings is less than 25% of consolidated net assets, then the allocation of consolidating adjustments to the subsidiaries to determine the amount of their adjusted net assets would not be necessary since no parent company disclosures would be required.

Question 2: If a registrant makes a decision that it will permanently reinvest the undistributed earnings of a subsidiary, and thus does not provide for income taxes thereon because it meets the criteria set forth in FASB ASC Subtopic 740-30, Income Taxes—Other Considerations or Special Areas, APB Opinion 23 [Topic 740], is there considered to be a restriction for purposes of the test?

Interpretive Response: No. The rules require that only third party restrictions be considered. Restrictions on subsidiary net assets imposed by management are not included.

b. Application of tests for parent company disclosures.

Facts: The balance sheet of the registrant's 100%-owned subsidiary at the most recent fiscal year-end is summarized as follows:

Current assets	\$ 120	Current liabilities	\$ 30
Noncurrent assets	45	Long-term debt	60
			90
		Common stock	25
		Retained earnings	50
			75
	\$ 165		\$ 165

Net assets of the subsidiary are \$75. Assume there are no consolidating adjustments to be allocated to the subsidiary. Restrictive covenants of the subsidiary's debt agreements provide that:

Net assets, excluding intercompany loans, cannot be less than \$35.

60% of accumulated earnings must be maintained.

Question 1: What is the amount of the subsidiary's restricted net assets?

Interpretive Response:

Restriction	Computed Restrictions
Net assets: currently \$75, cannot be less than \$35; therefore	\$35
Dividends: 60% of accumulated earnings (\$50) cannot be paid out; therefore	\$30

Restricted net assets for purposes of the test are \$35. The maximum amount that can be loaned or advanced to the parent without violating the net asset covenant is \$40 (\$75 - 35). Alternatively, the subsidiary could pay a dividend of up to \$20 (\$50 - 30) without violating the dividend covenant, and loan or advance up to \$20, without violating the net asset provision.

Facts: The registrant has one 100%-owned subsidiary. The balance sheet of the subsidiary at the latest fiscal year-end is summarized as follows:

Current assets	\$ 75	Current liabilities	\$ 23
Noncurrent assets	90	Long-term debt	57
		Redeemable preferred stock	10
		Common stock	30
		Retained earnings	45
			75
	\$ 165		\$ 165

Assume that the registrant's consolidated net assets are \$130 and there are no consolidating adjustments to be allocated to the subsidiary. The subsidiary's net assets are \$75. The subsidiary's noncurrent assets are comprised of \$40 in operating plant and equipment used in the subsidiary's business and a \$50 investment in a 30% investee. The subsidiary's equity in this investee's undistributed earnings is \$18. Restrictive covenants of the subsidiary's debt agreements are as follows:

1. Net assets, excluding intercompany balances, cannot be less than \$20.
2. 80% of accumulated earnings must be reinvested in the subsidiary.
3. Current ratio of 2:1 must be maintained.

Question 2: Are parent company footnote or schedule disclosures required?

Interpretive Response: Only the parent company footnote disclosures are required. The subsidiary's restricted net assets are computed as follows:

<u>Restriction</u>	<u>Computed Restriction</u>
Net assets: currently \$75, cannot be less than \$20; therefore	\$20
Dividends: 80% of accumulated earnings (\$45) cannot be paid; therefore	\$36
Current ratio: must be at least 2:1 (\$46 current assets must be maintained since current liabilities are \$23 at fiscal year-end); therefore	\$46

Restricted net assets for purposes of the test are \$20. The amount computed from the dividend restriction (\$36) and the current ratio requirement (\$46) are not used because net assets may be transferred by the subsidiary up to the limitation imposed by the requirement to maintain net assets of at least \$20, without violating the other restrictions. For example, a transfer to the parent of up to \$55 of net assets could be accomplished by a combination of

dividends of current assets of \$9 (\$45-36), and loans or advances of current assets of up to \$20 and noncurrent assets of up to \$26.

Parent company footnote disclosures are required in this example since the restricted net assets of the subsidiary and the registrant's equity in the earnings of its 100%-owned subsidiary's investee exceed 25% of consolidated net assets [ $(\$20 + 18)/\$130 = 29\%$ ]. The parent company schedule information is not required since the restricted net assets of the subsidiary are only 15% of consolidated net assets ( $\$20/\$130 = 15\%$ ).

Although the subsidiary's noncurrent assets are not in a form which is readily transferable to the parent company, the illiquid nature of the assets is not relevant for purposes of the parent company tests. The objective of the tests is to require parent company disclosures when the parent company does not have control of its subsidiaries' funds because it does not have unrestricted access to their net assets. The tests trigger parent company disclosures only when there are significant third party restrictions on transfers by subsidiaries of net assets and the subsidiaries' net assets comprise a significant portion of consolidated net assets. Practical limitations, other than third party restrictions on transferability at the measurement date (most recent fiscal year-end), such as subsidiary illiquidity, are not considered in computing restricted net assets. However, the potential effect of any limitations other than those imposed by third parties should be considered for inclusion in Management's Discussion and Analysis of liquidity.

	Net assets
Subsidiary A	\$ (500)
Subsidiary B	\$2,000
Consolidated	\$3,700

Subsidiaries A and B are 100% owned by the registrant. Assume there are no consolidating adjustments to be allocated to the subsidiaries. Subsidiary A has restrictions amounting to \$200. Subsidiary B's restrictions are \$1,000.

Question 3: What parent company disclosures are required for the registrant?

Interpretive Response: Since subsidiary A has an excess of liabilities over assets, it has no restricted net assets for purposes of the test. However, both parent company footnote and schedule disclosures are required, since the restricted net assets of subsidiary B exceed 25% of consolidated net assets ( $\$1,000/3,700 = 27\%$ ).

	Net assets
Subsidiary A	\$ 850
Subsidiary B	\$ 300
Consolidated	\$ 3700

The registrant owns 80% of subsidiary A. Subsidiary A owns 100% of subsidiary B. Assume there are no consolidating adjustments to be allocated to the subsidiaries. A may not pay any dividends or make any affiliate loans or advances. B has no restrictions. A's net assets of \$850 do not include its investment in B.

Question 4: Are parent company footnote or schedule disclosures required for this registrant?

Interpretive Response: No. All of the registrant's share of subsidiary A's net assets (\$680) are restricted. Although B may pay dividends and loan or advance funds to A, the parent's access to B's funds through A is restricted. However, since there are no limitations on B's ability to loan or advance funds to the parent, none of the parent's share of B's net assets are restricted. Since A's restricted net assets are less than 25% of consolidated net assets ( $\$680/\$3700 = 18\%$ ), no parent company disclosures are required.

Facts: The consolidating balance sheet of the registrant at the latest fiscal year-end is summarized as follows:

	Registrant	Subsidiary	Consolidating Adjustments	Consolidated
Current assets	\$ 800	\$ 700	\$0	\$ 1,500
30% investment in affiliate	175	0	0	175
Investment in subsidiary	350	0	(350)	0
Other noncurrent assets	\$ 625	\$ 300	(100)	\$ 825
	\$ 1,950	\$ 1,000	\$ (450)	\$ 2,500
Current liabilities	600	400	\$0	1,000
Concurrent liabilities	375	150	0	525
Redeemable preferred stock	275	0	0	275
Common stock	110	1	(1)	110
Paid-in capital	290	49	(49)	290
Retained earnings	300	400	(400)	300
	700	450	(450)	700
	\$ 1,950	\$ 1,000	\$ (450)	\$ 2,500

The acquisition of the 100%-owned subsidiary was consummated on the last day of the most recent fiscal year. Immediately preceding the acquisition, the registrant had net assets of \$700, which included its equity in the undistributed undisputed earnings of its 30% investee of \$75. Immediately after acquiring the subsidiary's net assets, which had an historical cost of \$450 and a fair value of \$350, the registrant's net assets were still \$700 since debt and preferred stock totaling \$350 were issued in the purchase.

The subsidiary has debt covenants which permit dividends, loans or advances, to the extent, if any, that net assets exceed an amount which is determined by the sum of \$100 plus 75% of the subsidiary's accumulated earnings.

Question 5: What is the amount of the subsidiary's restricted net assets? Are parent company footnote or schedule disclosures required?

Interpretive Response: Restricted net assets for purposes of the test are \$350, and both the parent company footnote and schedule disclosures are required.

The amount of the subsidiary's restrictions at year-end is \$400 [ $\$100 + (75\% \times \$400)$ ]. The subsidiary's adjusted net assets after the push down of the consolidation entry to the subsidiary to record the noncurrent assets acquired at their fair value is \$350 ( $\$450 - \$100$ ). Since the subsidiary's adjusted net assets (\$350) are less than the amount of its restrictions (\$400), restricted net assets are \$350. The computed percentages applicable to each of the disclosure tests is in excess of 25%. Therefore, both parent company footnote and schedule information are required. The percentage applicable to the footnote disclosure test is 61% [ $(\$75 + 350)/\$700$ ]. The computed percentage for the schedule disclosure is 50% ( $\$350/\$700$ ).

2. Amend paragraphs 205-20-S99-1 through S99-2, with no link to a transition paragraph, as follows:

## **Presentation of Financial Statements—Discontinued Operations**

### **SEC Materials**

#### **> SEC Staff Guidance**

#### **> > Staff Accounting Bulletins**

#### **> > > SAB Topic 5.Z.4, Disposal of Operation with Significant Interest Retained**

**205-20-S99-1** The following is the text of SAB Topic 5.Z.4, Disposal of Operation with Significant Interest Retained.

Facts: A Company disposes of its controlling interest in a component of an entity as defined by ~~Statement 144~~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 ~~Opinion 18 [paragraph 323-10-05-5]~~FASB ASC Subtopic 323-10, Investments—Equity Method and Joint Ventures—Overall, to account for its residual investment using the equity method. ~~FN63~~FN54

~~FN63~~FN54 In some circumstances, the seller's continuing interest may be so great that divestiture accounting is inappropriate. See SAB Topic 5.E.

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 ~~Statement 144 [Subtopic 205-20]~~FASB ASC Subtopic 205-20, Presentation of Financial Statements—Discontinued Operations?

Interpretive Response: No. A condition necessary for discontinued operations reporting, as indicated in ~~paragraph 42 of Statement 144 [paragraph 205-20-45-1]~~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 ~~Statement 144 [paragraph 360-10-45-5]~~FASB ASC paragraph 360-10-45-5 (Property, Plant, and Equipment Topic). ~~FN64~~FN55

~~FN64~~FN55 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.

### **>>> SAB Topic 5.Z.5, Classification and Disclosure of Contingencies Relating to Discontinued Operations**

**205-20-S99-2** The following is the text of SAB Topic 5.Z.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~~Statement 144 [paragraph 205-20-45-1]~~ 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. ~~FN56~~~~FN65~~ 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.

~~FN65~~~~FN56~~ Registrants are reminded that FASB ASC Topic 460, Guarantees~~Interpretation 45 [Subtopic 460-10]~~ requires recognition and disclosure of certain guarantees which may impose accounting and disclosure requirements in addition to those discussed in this SAB Topic.

FASB ASC paragraph 205-20-45-4~~Paragraph 44 of Statement 144 [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~~that paragraph 44~~

~~[paragraphs 205-20-45-4 through 45-5]~~ 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, paragraph 44 of Statement 144 ~~[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 ~~FN57FN66~~ 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, ~~FN58FN67~~ 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, Statement 5. MD&A should include discussion of the reasonably likely effects of these contingencies on reported results and liquidity. If the Company retains a financial interest in the discontinued component or in the buyer of that component that is material to the Company, MD&A should include discussion of known trends, events, and uncertainties, such as the financial condition and operating results of the issuer of the security, that may be reasonably expected to affect the amounts ultimately realized on the investments.

~~FN57FN66~~ Item 303 of Regulation S-K.

~~FN58FN67~~ Registrants also should consider the disclosure requirements of FASB ASC Topic 460, Interpretation 45 [~~Subtopic 460-10~~].

3. Amend paragraph 225-10-S99-4, with no link to a transition paragraph, as follows:

### **Income Statement—Overall**

#### **SEC Materials**

##### **> SEC Staff Guidance**

##### **> > Staff Accounting Bulletins**

##### **> > > SAB Topic 5.T, Accounting for Expenses or Liabilities Paid by Principal Stockholder(s)**

**225-10-S99-4** The following is the text of SAB Topic 5.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, Statement 5. A principal stockholder ~~FN34FN38~~ 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.

~~FN34FN38~~ The FASB ASC Master Glossary, Statement 57, paragraph 24e [~~the FASB Codification Glossary: **Principal Owners**~~] defines principal owners as "owners of record or known beneficial owners of more than 10 percent of the voting interests of the enterprise."

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), paragraph 11 of Statement of Financial Accounting Standards Statement No. 123 (revised 2004), Share-Based Payment (Statement 123R) [paragraph 718-10-15-4], 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 ~~FN35FN39~~ in the entity as compensation for services provided to the entity are share-based payment transactions to be

accounted for under this ~~Topic Statement~~ unless the transfer is clearly for a purpose other than compensation for services to the reporting entity. As explained in ~~this paragraph 41 of Statement 123R [paragraph 718-10-15-4]~~, 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.

~~FN35FN39~~ The FASB ASC Master Glossary~~Statement 123R [Topic 718]~~ 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.

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~~Statement 123R [Topic 718]~~ is not limited to transactions involving stock compensation. Therefore, similar accounting is required in this and other ~~FN36FN40~~ 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.

~~FN36FN40~~ 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.

Some registrants and their accountants have taken the position that since FASB ASC Topic 850, Related Party Disclosures~~Statement 57 [Topic 850]~~ 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~~Statement 123R, paragraph 41 [paragraph 718-10-15-4]~~ for transactions other than those specifically covered by it. The staff notes, however, that FASB ASC Topic 850~~Statement 57 [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. ~~FN37FN44~~ However, the staff believes that transactions of the type described above differ from the typical related party transactions.

~~FN37FN44~~ 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).

The transactions for which FASB ASC Topic 850 ~~Statement 57~~ [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.

4. Amend paragraph 235-10-S99-5, with no link to a transition paragraph, as follows:

## **Notes to Financial Statements—Overall**

### **SEC Materials**

#### **> SEC Staff Guidance**

#### **> > Staff Accounting Bulletins**

#### **> > > SAB Topic 1.D.1, Disclosures Required of Companies Complying with Item 18 of Form 20-F**

**235-10-S99-5** The following is the text of SAB Topic 1.D.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, ~~Forms~~ Form F-3 and F-2 require 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 ~~4~~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 ~~Statement 57~~ Subtopic 850-10 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.

5. Amend paragraphs 250-10-S99-1 through S99-5, with no link to a transition paragraph, as follows:

## **Accounting Changes and Error Corrections—Overall**

### **SEC Materials**

#### **SEC Staff Guidance**

##### **> > Staff Accounting Bulletins**

##### **> > > SAB Topic 1.M, Assessing Materiality**

**250-10-S99-1** The following is the text of SAB Topic 1.M, Assessing 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. FN24

FN24 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.

Question: FASB ASC paragraph 105-10-05-6 (Generally Accepted Accounting Principles Topic) Each Statement of Financial

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

Interpretive Response: No. The staff is aware that certain registrants, over time, have developed quantitative thresholds as "rules of thumb" to assist in the preparation of their financial statements, and that auditors also have used these thresholds in their evaluation of whether items might be considered material to users of a registrant's financial statements. One rule of thumb in particular suggests that the misstatement or omission FN25 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.

FN25 As used in this SAB, "misstatement" or "omission" refers to a financial statement assertion that would not be in conformity with GAAP.

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. FN26

FN26 Concepts Statement 2, paragraph 132.  
See also Concepts Statement 2, Glossary of Terms - Materiality.

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. FN27

FN27 TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976). See also Basic, Inc. v. Levinson, 485 U.S. 224 (1988). As the Supreme Court has noted, determinations of materiality require "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him...." TSC Industries, 426 U.S. at 450.

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. FN28 Court decisions, Commission rules and enforcement actions, and accounting and auditing literature FN29 have all considered "qualitative" factors in various contexts.

FN28 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.

FN29 See, e.g., Rule 1-02(o) of Regulation S-X, 17 CFR 210.1-02(o), Rule 405 of Regulation C, 17 CFR 230.405, and Rule 12b-2, 17 CFR 240.12b-2; AU 312A.10 -.11, 317.13, 411.04 n. 1, and 508.36; In re Kidder Peabody Securities Litigation, 10 F. Supp. 2d 398 (S.D.N.Y. 1998); Parnes v. Gateway 2000, Inc., 122 F.3d 539 (8th Cir. 1997); In re Westinghouse Securities Litigation, 90 F.3d 696 (3d Cir. 1996); In the Matter of W.R. Grace & Co., Accounting and Auditing Enforcement Release ("AAER") 1140 (June 30, 1999); In the Matter of Eugene Gaughan, AAER 1141 (June 30, 1999); In the Matter of Thomas Scanlon, AAER 1142 (June 30, 1999); and In re Sensormatic Electronics Corporation, Sec. Act Rel. No. 7518 (March 25, 1998).

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. FN30

FN30 Concepts Statement 2, paragraph 131.

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. FN31 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. FN32 The FASB also considered whether an evaluation of materiality could be based solely on anticipating the market's reaction to accounting information. FN33

FN31 Concepts Statement 2, paragraphs 131 and 166.

FN32 Concepts Statement 2, paragraph 167.

FN33 Concepts Statement 2, paragraphs 168-169.

The FASB rejected a formulaic approach to discharging "the onerous duty of making materiality decisions" FN34 in favor of an approach that takes into account all the relevant considerations. In so doing, it made clear that –

FN34 Concepts Statement 2, paragraph 170.

[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. FN35

FN35 Concepts Statement 2, paragraph 125.

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. FN36

FN36 AU 312.11.

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 FN37.

FN37 As stated in Concepts Statement 2, paragraph 130: Another factor in materiality judgments is the degree of precision that is attainable in estimating the judgment item. The amount of deviation that is considered immaterial may increase as the attainable degree of precision decreases. For example, accounts payable usually can be estimated more accurately than can contingent liabilities arising from litigation or threats of it, and a deviation considered to be material in the first case may be quite trivial in the second. This SAB is not intended to change current law or guidance in the accounting literature regarding accounting estimates. See, e.g., Accounting Principles Board Opinion 20, Accounting Changes 10, 11, 31-33 (July 1971) [Subtopic 250-10].

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. FN38 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. FN39 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. FN40

FN38 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).

FN39 See Concepts Statement 2, paragraph 169.

FN40 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.

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. FN41 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. FN42 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.

FN41 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.

FN42 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).

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. FN43 "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" FN44 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 -

FN43 See, e.g., In the Matter of W.R. Grace & Co., AAER 1140 (June 30, 1999).

FN44 AU 9326.33.

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. FN45

FN45 Id.

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. FN46 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." FN47 This requires consideration of –

FN46 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.

FN47 AU 312.34. Quantitative materiality assessments often are made by comparing adjustments to revenues, gross profit, pretax and net income, total assets, stockholders' equity, or individual line items in the financial statements. The particular items in the financial statements to be considered as a basis for the materiality determination depend on the proposed adjustment to be made and other factors, such as those identified in this SAB. For example, an adjustment to inventory that is immaterial to pretax income or net income may be material to the financial statements because it may affect a working capital ratio or cause the registrant to be in default of loan covenants.

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.... FN48

FN48 AU 508.36.

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. FN49

#### FN49 AU 312.34.

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. FN50

FN50 AU 380.09.

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, FN51 registrants must comply with Sections 13(b)(2) - (7) of the Securities Exchange Act of 1934 (the "Exchange Act"). FN52 Under these provisions, each registrant with securities registered pursuant to Section 12 of the Exchange Act, FN53 or required to file reports pursuant to Section 15(d), FN54 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. FN55 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. FN56 Accordingly, failure to record accurately immaterial items, in some instances, may result in violations of the securities laws.

FN51 FASB ASC paragraph 105-10-05-6 states ~~Statements generally provide that "[t]he provisions of the Codification this Statement need not be applied to immaterial items."~~ This SAB is consistent with that provision of the Codification, Statements. 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.

FN52 15 U.S.C. 78m(b)(2) - (7).

FN53 15 U.S.C. 78l.

FN54 15 U.S.C. 78o(d).

FN55 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."

FN56 15 U.S.C. 78m(b)(7). The books and records provisions of section 13(b) of the Exchange Act originally were passed as part of the Foreign Corrupt Practices Act ("FCPA"). In the conference committee report regarding the 1988 amendments to the FCPA, the committee stated: The conference committee adopted the prudent man qualification in order to clarify that the current standard does not connote an unrealistic degree of exactitude or precision. The concept of reasonableness of necessity contemplates the weighing of a number of relevant factors, including the costs of compliance. Cong. Rec. H2116 (daily ed. April 20, 1988).

The staff recognizes that there is limited authoritative guidance FN57 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. FN58 In his address, Chairman Williams noted that, like materiality, "reasonableness" is not an "absolute standard of exactitude for corporate records." FN59 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. FN60

FN57 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).

FN58 The Commission adopted the address as a formal statement of policy in Securities Exchange Act Release No. 17500 (January 29, 1981), 46 FR 11544 (February 9, 1981), 21 SEC Docket 1466 (February 10, 1981).

FN59 *Id.* at 46 FR 11546.

FN60 *Id.*

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." FN61

FN61 For example, the conference report regarding the 1988 amendments to the FCPA stated: The Conferees intend to codify current Securities and Exchange

Commission (SEC) enforcement policy that penalties not be imposed for insignificant or technical infractions or inadvertent conduct. The amendment adopted by the Conferees [Section 13(b)(4)] accomplishes this by providing that criminal penalties shall not be imposed for failing to comply with the FCPA's books and records or accounting provisions. This provision [Section 13(b)(5)] is meant to ensure that criminal penalties would be imposed where acts of commission or omission in keeping books or records or administering accounting controls have the purpose of falsifying books, records or accounts, or of circumventing the accounting controls set forth in the Act. This would include the deliberate falsification of books and records and other conduct calculated to evade the internal accounting controls requirement. Cong. Rec. H2115 (daily ed. April 20, 1988).

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. FN62 Conversely, where there is little cost or delay involved in correcting a misstatement, failing to do so is unlikely to be "reasonable."

FN62 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.

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." FN63

FN63 Id., at 11547.

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." FN64 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.

FN64 Section 10A(f) defines, for purposes of Section 10A, an "illegal act" as "an act or omission that violates any law, or any rule or regulation having the force of law." This is broader than the definition of an "illegal act" in AU 317.02, which states, "Illegal acts by clients do not include personal misconduct by the entity's personnel unrelated to their business activities."

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

The requirements of Section 10A echo the auditing literature. See, e.g. Statement on Auditing Standards (SAS) for example, SAS Nos. 54 and 99. Pursuant to paragraph 77 of SAS 99, if the auditor determines there is evidence that fraud may exist, the auditor must discuss the matter with the appropriate level of management that is at least one level above those involved, and with senior management and the audit committee. The auditor must report directly to the audit committee fraud involving senior management and fraud that causes a material misstatement of the financial statements. Paragraph 6 of SAS 99 states that "misstatements arising from fraudulent financial reporting are intentional misstatements or omissions of amounts or disclosures in financial statements designed to deceive financial statement users..." FN65 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. FN66 The clear implication of SAS 99 is that immaterial misstatements may be fraudulent financial reporting. FN67

FN65 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.

FN66 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.

FN67 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. ~~{remove paragraph return}~~FN67—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.

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. FN68

FN68 Auditors should document their determinations in accordance with SAS 96, SAS 99, and other appropriate sections of the audit literature.

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. FN69 As stated by the National Commission on Fraudulent Financial Reporting, also known as the Treadway Commission, in its 1987 report,

FN69 See, e.g., SAS 99.

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. FN70

FN70 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).

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. FN71

FN71 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.

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. FN72

FN72 See AU 411.05.

#### General comments.

This SAB is not intended to change current law or guidance in the accounting or auditing literature. FN73 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.

FN73 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.

### >>> **SAB Topic 1.N, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements**

**250-10-S99-2** The following is the text of SAB Topic 1.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. FN74 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.

FN74 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~~FASB Statement 154, Accounting Changes and Error Corrections, paragraph 2 [Section 250-10-20]~~, for the distinction between an error and a change in accounting estimate.

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 registrants 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. FN75 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.

FN75 Topic 1N addresses certain of these quantitative issues, but does not alter the analysis required by Topic 1M.

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 misstatements 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, ~~FASB Concepts Statement No. 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 ***{add italics}*** by the inclusion or correction of the item”***{add italics}*** (emphasis added). FN76 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 registrants financial statements would require adjustment when either approach results in quantifying a misstatement that is material, after considering all relevant quantitative and qualitative factors.

FN76 Concepts Statement 2, paragraph 132. See also Concepts Statement 2, Glossary of Terms - Materiality.

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. FN77

FN77 See definition of “error in previously issued financial statements” in the FASB ASC Master Glossary, Statement 154, paragraph 2h [Section 250-10-20].

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 registrants financial statements would need to be adjusted.

It is possible that correcting an error in the current year could materially misstate the current years 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 ~~staffs~~ 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 registrants 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, Statement 154 [paragraph 250-10-45-23]. FN78

~~FN78 FASB ASC paragraph 250-10-45-23, Statement 154, paragraph 25 [paragraph 250-10-45-23].~~

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 FN79 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.

FN79 If a registrants initial registration statement is not effective on or before November 15, 2006, and the registrants 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, Statement 154, paragraph 25 [paragraph 250-10-45-23]~~. If a registrants initial registration statement is effective on or before November 15, 2006, the guidance in the interpretive response to Question 3 is applicable.

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.

### **>>> SAB Topic 5.F, Accounting Changes Not Retroactively Applied Due to Immateriality**

**250-10-S99-3** The following is the text of SAB Topic 5.F, Accounting Changes Not Retroactively Applied Due to Immateriality.

Facts: A registrant is required to adopt an accounting principle by means of ~~restatement~~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 ~~restate~~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 ~~restated~~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 (~~not to be reported as a cumulative effect adjustment in the manner of APB Opinion 20 [Topic 250]~~). Even in cases where the total cumulative effect is not significant, the staff believes that the amount should be reflected in the results of operations for the period in which the change is made. However, if the cumulative effect is material to current operations or to the trend of the reported results of operations, then the individual income statements of the earlier years should be ~~retroactively~~retrospectively adjusted.

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

## >>> SAB Topic 6.G. 2.b, Reporting Requirements for Accounting Changes

**250-10-S99-4** The following is the text of SAB Topic 6.G.2.b, Reporting Requirements for Accounting Changes.

b. Reporting requirements for accounting changes.

1. Preferability.

Facts: Rule 10-01(b)(6) of Regulation S-X requires that a registrant who makes a material change in its method of accounting shall indicate the date of and the reason for the change. The registrant also must include as an exhibit in the first Form 10-Q filed subsequent to the date of an accounting change, a letter from the registrant's independent accountants indicating whether or not the change is to an alternative principle which in his judgment is preferable under the circumstances. A letter from the independent

accountant is not required when the change is made in response to a standard adopted by the Financial Accounting Standards Board which requires such a change.

Question 1: For some alternative accounting principles, authoritative bodies have specified when one alternative is preferable to another. However, for other alternative accounting principles, no authoritative body has specified criteria for determining the preferability of one alternative over another. In such situations, how should preferability be determined?

Interpretive Response: In such cases, where objective criteria for determining the preferability among alternative accounting principles have not been established by authoritative bodies, the determination of preferability should be based on the particular circumstances described by and discussed with the registrant. In addition, the independent accountant should consider other significant information of which he is aware. FN5

FN5 Registrants also are reminded that FASB ASC paragraph 250-10-50-1 (Accounting Changes and Error Corrections Topic) paragraph 17 of APB Opinion 20 [paragraphs 250-10-50-1 through 50-2] requires that companies disclose the nature of and justification for the change as well as the effects of the change on net income for the period in which the change is made. Furthermore, the justification for the change should explain clearly why the newly adopted principle is preferable to the previously-applied principle.

Question 2: Management may offer, as justification for a change in accounting principle, circumstances such as: their expectation as to the effect of general economic trends on their business (e. g., the impact of inflation), their expectation regarding expanding consumer demand for the company's products, or plans for change in marketing methods. Are these circumstances which enter into the determination of preferability?

Interpretive Response: Yes. Those circumstances are examples of business judgment and planning and should be evaluated in determining preferability. In the case of changes for which objective criteria for determining preferability have not been established by authoritative bodies, business judgment and business planning often are major considerations in determining that the change is to

a preferable method because the change results in improved financial reporting.

Question 3: What responsibility does the independent accountant have for evaluating the business judgment and business planning of the registrant?

Interpretive Response: Business judgment and business planning are within the province of the registrant. Thus, the independent accountant may accept the registrant's business judgment and business planning and express reliance thereon in his letter. However, if either the plans or judgment appear to be unreasonable to the independent accountant, he should not accept them as justification. For example, an independent accountant should not accept a registrant's plans for a major expansion if he believes the registrant does not have the means of obtaining the funds necessary for the expansion program.

Question 4: If a registrant, who has changed to an accounting method which was preferable under the circumstances, later finds that it must abandon its business plans or change its business judgment because of economic or other factors, is the registrant's justification nullified?

Interpretive Response: No. A registrant must in good faith justify a change in its method of accounting under the circumstances which exist at the time of the change. The existence of different circumstances at a later time does not nullify the previous justification for the change.

Question 5: If a registrant justified a change in accounting method as preferable under the circumstances, and the circumstances change, may the registrant revert to the method of accounting used before the change?

Interpretive Response: Any time a registrant makes a change in accounting method, the change must be justified as preferable under the circumstances. Thus, a registrant may not change back to a principle previously used unless it can justify that the previously used principle is preferable in the circumstances as they currently exist.

Question 6: If one client of an independent accounting firm changes its method of accounting and the accountant submits the required

letter stating his view of the preferability of the principle in the circumstances, does this mean that all clients of that firm are constrained from making the converse change in accounting (e. g., if one client changes from FIFO to LIFO, can no other client change from LIFO to FIFO)?

Interpretive Response: No. Each registrant must justify a change in accounting method on the basis that the method is preferable under the circumstances of that registrant. In addition, a registrant must furnish a letter from its independent accountant stating that in the judgment of the independent accountant the change in method is preferable under the circumstances of that registrant. If registrants in apparently similar circumstances make changes in opposite directions, the staff has a responsibility to inquire as to the factors which were considered in arriving at the determination by each registrant and its independent accountant that the change was preferable under the circumstances because it resulted in improved financial reporting. The staff recognizes the importance, in many circumstances, of the judgments and plans of management and recognizes that such management judgments may, in good faith, differ. As indicated above, the concern relates to registrants in apparently similar circumstances, no matter who their independent accountants may be.

Question 7: If a registrant changes its accounting to one of two methods specifically approved by the FASB in the Accounting Standards Codification, a Statement of Financial Accounting Standards, need the independent accountant express his view as to the preferability of the method selected?

Interpretive Response: If a registrant was formerly using a method of accounting no longer deemed acceptable, a change to either method approved by the FASB may be presumed to be a change to a preferable method and no letter will be required from the independent accountant. If, however, the registrant was formerly using one of the methods approved by the FASB for current use and wishes to change to an alternative approved method, then the registrant must justify its change as being one to a preferable method in the circumstances and the independent accountant must submit a letter stating that in his view the change is to a principle that is preferable in the circumstances.

2. Filing of a letter from the accountants.

Facts: The registrant makes an accounting change in the fourth quarter of its fiscal year. Rule 10-01(b)(6) of Regulation S-X requires that the registrant file a letter from its independent accountants stating whether or not the change is preferable in the circumstances in the next Form 10-Q. Item 601(b)(18) of Regulation S-K provides that the independent accountant's preferability letter be filed as an exhibit to reports on Forms 10-K or 10-Q.

Question: When the independent accountant's letter is filed with the Form 10-K, must another letter also be filed with the first quarter's Form 10-Q in the following year?

Interpretive Response: No. A letter is not required to be filed with Form 10-Q if it has been previously filed as an exhibit to the Form 10-K.

**> > > SAB Topic 11.M, Disclosure of the Impact that Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant when Adopted in a Future Period**

**250-10-S99-5** The following is the text of SAB Topic 11.M, Disclosure of the Impact that Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant when Adopted in a Future Period.

Facts: An accounting standard has been issued FN5 that does not require adoption until some future date. A registrant is required to include financial statements in filings with the Commission after the issuance of the standard but before it is adopted by the registrant.

FN5 Some registrants may want to disclose the potential effects of proposed accounting standards not yet issued, (e. g., exposure drafts). Such disclosures, which generally are not required because the final standard may differ from the exposure draft, are not addressed by this SAB. See also FRR 26.

Question 1: Does the staff believe that these filings should include disclosure of the impact that the recently issued accounting standard will have on the financial position and results of operations of the registrant when such standard is adopted in a future period?

Interpretive Response: Yes. The Commission addressed a similar issue with respect to Statement 52 [Topic 830] and concluded that "The Commission also believes that registrants that have not yet adopted Statement 52 [Topic

~~830]~~ should discuss the potential effects of adoption of recently issued accounting standards in registration statements and reports filed with the Commission. ~~Commission.~~ FN6 The staff believes that this disclosure guidance applies to all accounting standards which have been issued but not yet adopted by the registrant unless the impact on its financial position and results of operations is not expected to be material. FN7 MD&A FN8 requires registrants to provide information with respect to liquidity, capital resources and results of operations and such other information that the registrant believes to be necessary to understand its financial condition and results of operations. In addition, MD&A requires disclosure of presently known material changes, trends and uncertainties that have had or that the registrant reasonably expects will have a material impact on future sales, revenues or income from continuing operations. The staff believes that disclosure of impending accounting changes is necessary to inform the reader about expected impacts on financial information to be reported in the future and, therefore, should be disclosed in accordance with the existing MD&A requirements. With respect to financial statement disclosure, GAAS FN9 specifically address the need for the auditor to consider the adequacy of the disclosure of impending changes in accounting principles if (a) the financial statements have been prepared on the basis of accounting principles that were acceptable at the financial statement date but that will not be acceptable in the future and (b) the financial statements will be retrospectively adjusted ~~restated~~ in the future as a result of the change. The staff believes that recently issued accounting standards may constitute material matters and, therefore, disclosure in the financial statements should also be considered in situations where the change to the new accounting standard will be accounted for in financial statements of future periods, prospectively or with a cumulative catch-up adjustment.

FN6 FRR 6, Section 2.

FN7 In those instances where a recently issued standard will impact the preparation of, but not materially affect, the financial statements, the registrant is encouraged to disclose that a standard has been issued and that its adoption will not have a material effect on its financial position or results of operations.

FN8 Item 303 of Regulation S-K.

FN9 See AU 9410.13-18.

Question 2: Does the staff have a view on the types of disclosure that would be meaningful and appropriate when a new accounting standard has been issued but not yet adopted by the registrant?

Interpretive Response: The staff believes that the registrant should evaluate each new accounting standard to determine the appropriate disclosure and recognizes that the level of information available to the registrant will differ with respect to various standards and from one registrant to another. The objectives of the disclosure should be to (1) notify the reader of the disclosure documents that a standard has been issued which the registrant will be required to adopt in the future and (2) assist the reader in assessing the significance of the impact that the standard will have on the financial statements of the registrant when adopted. The staff understands that the registrant will only be able to disclose information that is known.

The following disclosures should generally be considered by the registrant:

A brief description of the new standard, the date that adoption is required and the date that the registrant plans to adopt, if earlier.

A discussion of the methods of adoption allowed by the standard and the method expected to be utilized by the registrant, if determined.

A discussion of the impact that adoption of the standard is expected to have on the financial statements of the registrant, unless not known or reasonably estimable. In that case, a statement to that effect may be made.

Disclosure of the potential impact of other significant matters that the registrant believes might result from the adoption of the standard (such as technical violations of debt covenant agreements, planned or intended changes in business practices, etc.) is encouraged.

6 Amend paragraph 260-10-S99-1, with no link to a transition paragraph, as follows:

**Earnings Per Share—Overall**

**SEC Materials**

**> SEC Staff Guidance**

**> > Staff Accounting Bulletins**

**> > > SAB Topic 4.D, Earnings Per Share Computations in an Initial Public Offering**

**260-10-S99-1** The following is the text of SAB Topic 4.D. Earnings Per Share Computations in an Initial Public Offering.

~~(Question 2 replaced by SAB 107).~~

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 FN1 common stock, options or warrants to purchase common stock or other potentially dilutive instruments (collectively, referred to hereafter as "nominal issuances").

FN1 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.

Prior to the effective date of FASB ASC Topic 260, Earnings Per Share, Statement 128, the staff believed that certain stock and warrants FN2 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.

FN2 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.

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, Statement 128?

Interpretive Response: Generally, no. Historical EPS should be prepared and presented in conformity with FASB ASC Topic 260, Statement 128 [Topic 260].

In applying the requirements of FASB ASC Topic 260, Statement 128 [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, paragraph 54 of Statement 128 [paragraph 260-10-55-12]. In computing diluted EPS for such periods, nominal issuances of common stock and potential common

stock FN3 should be reflected in a manner similar to a stock split or stock dividend.

FN3 ~~The FASB ASC Master Glossary, Statement 128 [Topic 260]~~ 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."

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

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

Interpretive Response: No. Registrants must follow GAAP in determining whether the recognition of compensation expense for any issuances of equity instruments to employees is necessary. FN4 Reflecting nominal issuances as outstanding for all historical periods in the computation of earnings per share does not alter that existing responsibility under GAAP.

FN4 As prescribed by FASB ASC Topic 718, Compensation—Stock Compensation, Statement 123R [Topic 718].

7. Amend paragraph 310-10-S99-1, with no link to a transition paragraph, as follows:

**Receivables—Overall**

**SEC Materials**

**> SEC Staff Guidance**

**>> Staff Accounting Bulletins**

**>>> SAB Topic 1.I, Financial Statements of Properties Securing Mortgage Loans**

**310-10-S99-1** The following is the text of SAB Topic 1.1, 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 ~~Exhibit I to the Appendix of the American Institute of Certified Public Accountants' Practice Bulletin 1 FN6 "ADC FN7 Arrangements" ("Exhibit I to PB1")~~ [paragraph 310-10-25-19] the Acquisition, Development, and Construction Arrangements (ADC Arrangements) Subsections of FASB ASC Subtopic 310-10, Receivables—Overall FN6 FN7. In September 1986 the EITF FN8 reached a consensus on this issue FN9 to the effect that, although ~~Exhibit I to PB1~~ the guidance in the ADC Arrangements Subsections of FASB ASC Subtopic 310-10 was issued to address the real estate ADC arrangements of financial institutions, preparers and auditors should consider ~~that~~ the ~~guidance contained in Exhibit I to PB1~~ 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.

~~FN6 "ADC Arrangements" was originally issued as a notice to practitioners (February 1986, as published in the April 1986 issue of the Journal of Accountancy). The notice to practitioners was reprinted without change as Exhibit I to the Appendix of the American Institute~~

~~of Certified Public Accountants' Practice Bulletin 1 (November, 1987). [Original footnote removed by SAB 114.]~~

~~FN7 Acquisition, development and construction. [Original footnote removed by SAB 114.]~~

FN8 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.

FN9 ~~See Issue 86-24~~ FASB ASC paragraph 310-10-05-9.

~~Statement 133, as amended by Statements 137 and 138 [Subtopic 815-15], FASB ASC Topic 815, 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 ~~the~~ expected residual profit component of an ADC arrangement need not be separately accounted for as a derivative under ~~Statement 133 [Subtopic 815-15]~~ Statement 133 [Subtopic 815-15] FASB ASC Topic 815, then the disclosure requirements discussed below for ADC loans and similar arrangements should be followed. FN10~~

FN10 The equity kicker (the expected residual profit) would typically not be separated from the host contract and accounted for as a derivative because ~~paragraph 12(c) of Statement 133 [paragraph 815-15-25-4]~~ paragraph 12(c) of Statement 133 [paragraph 815-15-25-1(c)] 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 ~~Statement 133 [Subtopic 815-15]~~ Statement 133 [Subtopic 815-15] FASB ASC Topic 815.

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. FN11 In addition, ~~Exhibit I to PB1 [paragraph 310-10-25-49]~~ Exhibit I to PB1 [paragraph 310-10-25-49] the ADC Arrangements Subsections of FASB ASC Subtopic 310-10 include a number of other characteristics which, when considered individually or in combination, would suggest that the risks of an ADC arrangement are similar to those associated with an investment in real estate or a joint venture or, conversely, that they are similar to those associated with a loan. Among those other characteristics is whether the lender agrees to provide all or substantially all necessary funds to acquire the property, resulting in the borrower having title to, but little or no equity

in, the underlying property. The staff believes that the borrower's equity in the property is adequate to support accounting for the transaction as a mortgage loan when the borrower's initial investment meets the criteria in ~~paragraph 11 of Statement 66 [paragraph 360-20-40-18]~~FASB ASC paragraph 360-20-40-18 (Property, Plant, and Equipment Topic) FN12 and the borrower's payments of principal and interest on the loan are adequate to maintain a continuing investment in the property which meets the criteria in ~~paragraph 12 of Statement 66 [paragraphs 360-20-40-19 and 360-20-40-20]~~FASB ASC paragraph 360-20-40-19. FN13

FN11 Expected residual profit is defined in ~~Exhibit I to PB1 [Section 310-10-20]~~the ADC Arrangements Subsections 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."

FN12 ~~Statement 66 [Subtopic 976-605]~~FASB ASC Subtopic 360-20 establishes standards for the recognition of profit on real estate sales transactions. ~~Paragraph 11 [paragraph 360-20-40-18]~~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 ~~paragraphs 53 and 54 of Statement 66 [paragraphs 360-20-55-1 and 360-20-55-2]~~FASB ASC paragraphs 360-20-55-1 and 360-20-55-2.

FN13 ~~Paragraph 12 of Statement 66 [paragraph 360-20-40-19]~~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.

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. FN14 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. FN15

FN14 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.

FN15 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."

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

Question 3: The interpretive response to question 1 indicates that the staff believes that the borrower's equity in an operating property is adequate to support accounting for the transaction as a mortgage loan when the borrower's initial investment meets the criteria in ~~paragraph 11 of Statement 66 [paragraph 360-20-40-18]~~ 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 ~~paragraph 12 of Statement 66 [paragraphs 360-20-40-19 and 360-20-40-20]~~ 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 Exhibit I to the Appendix of the American Institute of Certified Public Accountants Practice Bulletin 1 (November, 1987) ("Exhibit~~

I to PB1") [Section 310-10-25] the ADC Arrangements Subsections of FASB ASC Subtopic 310-10. As stated in Exhibit I to PB1 [Section 310-10-25] those Subsections, 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. FN16 The criteria described in Statement 66 [Subtopic 360-20] 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 Statement 66 [Subtopic 360-20] FASB ASC Subtopic 360-20.

FN16 Regarding the composition of the borrower's investment, paragraph 9b of Exhibit I to PB1 [paragraph 310-10-25-20] 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.

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 ongoing, 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. FN17

FN17 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.

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.

8. Amend paragraph 310-10-S99-4, with no link to a transition paragraph, as follows:

## **Receivables—Overall**

### **SEC Materials**

#### **> > > SAB Topic 6.L, Financial Reporting Release 28—Accounting for Loan Losses by Registrants Engaged in Lending Activities**

**310-10-S99-4** The following is the text of SAB Topic 6.L, Financial Reporting Release 28—Accounting for Loan Losses by Registrants Engaged in Lending Activities.

##### 1. Accounting for loan losses

General: GAAP for recognition of loan losses is provided by ~~Statements 5 [Topic 450] and 114 [Topic 310]~~FASB ASC Subtopic 450-20, Contingencies—Loss Contingencies, and FASB ASC Subtopic 310-10, Receivables—Overall. FN6 An estimated loss from a loss contingency, such as the collectibility of receivables, should be accrued when, based on information available prior to the issuance of the financial statements, it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statements and the amount of the loss can be reasonably estimated. FN7 ~~Statement 114 [Topic 310]~~FASB ASC Subtopic 310-10 provides more specific guidance on measurement of loan impairment and related disclosures but does not change the fundamental recognition criteria for loan losses provided by ~~Statement 5 [Topic 450]~~FASB ASC Subtopic 450-20. ~~Additional guidance on the recognition, measurement, and disclosure of loan losses is provided by EITF Topic~~

~~D-80 [Topic 310], Interpretation 14 [Topic 450], and the AICPA Audit and Accounting Guide, Banks and Savings Institutions [Topic 942].~~

~~FN6 As amended by Statement 118. [Original footnote removed by SAB 114.]~~

~~FN7 Paragraph 8 of Statement 5 [paragraph 450-20-25-2] FASB ASC paragraph 450-20-25-2.~~

Further guidance for SEC registrants is provided by FRR 28, which added subsection (b), Procedural Discipline in Determining the Allowance and Provision for Loan Losses to be Reported, of Section 401.09, Accounting for Loan Losses by Registrants Engaged in Lending Activities, to the Codification of Financial Reporting Policies (hereafter referred to as FRR 28). Additionally, public companies are required to comply with the books and records provisions of the Securities Exchange Act of 1934 (Exchange Act). Under Sections 13(b)(2) - (7) of the Exchange Act, registrants must make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of assets of the registrant. Registrants also must maintain internal accounting controls that are sufficient to provide reasonable assurances that, among other things, transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP.

This staff interpretation applies to all registrants that are creditors in loan transactions that, individually or in the aggregate, have a material effect on the registrant's financial statements. FN8.

~~FN8 For purposes of this interpretation, a loan is defined (consistent with paragraph 4 of Statement 114 the FASB ASC Master Glossary) as a contractual right to receive money on demand or on fixed or determinable dates that is recognized as an asset in the creditor's statement of financial position. For purposes of this interpretation, loans do not include trade accounts receivable or notes receivable with terms less than one year or debt securities subject to the provisions of Statement 115 [Subtopic 320-10] FASB ASC Topic 320, Investments—Debt and Equity Securities.~~

## 2. Developing and documenting a systematic methodology

### a. Developing a systematic methodology.

Facts: Registrant A, or one of its consolidated subsidiaries, engages in lending activities and is developing or performing a review of its loan loss allowance methodology.

Question: What are some of the factors or elements that the staff normally would expect Registrant A to consider when developing (or subsequently performing an assessment of) its methodology for determining its loan loss allowance under GAAP?

Interpretive Response: The staff normally would expect a registrant that engages in lending activities to develop and document a systematic methodology FN9 to determine its provision for loan losses and allowance for loan losses as of each financial reporting date. It is critical that loan loss allowance methodologies incorporate management's current judgments about the credit quality of the loan portfolio through a disciplined and consistently applied process. A registrant's loan loss allowance methodology is influenced by entity-specific factors, such as an entity's size, organizational structure, business environment and strategy, management style, loan portfolio characteristics, loan administration procedures, and management information systems.

FN9 FRR 28 states that " the Commission's staff normally would expect to find that the books and records of registrants engaged in lending activities include documentation of [the]: (a) systematic methodology to be employed each period in determining the amount of the loan losses to be reported, and (b) rationale supporting each period's determination that the amounts reported were ~~adequate-adequate.~~"

However, as indicated in the AICPA Audit and Accounting Guide, Banks and Savings Depository and Lending Institutions with Conforming Changes as of June 1, 2009 (Audit Guide), "~~while~~ while different institutions may use different methods, there are certain common elements that should be included in any [loan loss allowance] methodology for it to be ~~effective-effective.~~ FN10 A registrant's loan loss allowance methodology generally should: FN11.

FN10 See ~~paragraph 7.05~~paragraph 9.05 of the Audit Guide.

FN11 Ibid.

Include a detailed analysis of the loan portfolio, performed on a regular basis;

Consider all loans (whether on an individual or group basis);

Identify loans to be evaluated for impairment on an individual basis under Statement 114 [Topic 310] FASB ASC Subtopic 310-10 and segment the remainder of the portfolio into groups of loans with similar risk characteristics for evaluation and analysis under Statement 5 [Topic 450] FASB ASC Subtopic 450-20;

Consider all known relevant internal and external factors that may affect loan collectibility;

Be applied consistently but, when appropriate, be modified for new factors affecting collectibility;

Consider the particular risks inherent in different kinds of lending;

Consider current collateral values (less costs to sell), where applicable;

Require that analyses, estimates, reviews and other loan loss allowance methodology functions be performed by competent and well-trained personnel;

Be based on current and reliable data;

Be well documented, in writing, with clear explanations of the supporting analyses and rationale (see Question 2 below for staff views on documenting a loan loss allowance methodology); and

Include a systematic and logical method to consolidate the loss estimates and ensure the loan loss allowance balance is recorded in accordance with GAAP.

For many entities engaged in lending activities, the allowance and provision for loan losses are significant elements of the financial statements.

Therefore, the staff believes it is appropriate for an entity's management to review, on a periodic basis, its methodology for

determining its allowance for loan losses. FN12 Additionally, for registrants that have audit committees, the staff believes that oversight of the financial reporting and auditing of the loan loss allowance by the audit committee can strengthen the registrant's control system and process for determining its allowance for loan losses. FN13

FN12 For federally insured depository institutions, the December 21, 1993 "Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL)" (the 1993 Interagency Policy Statement) indicates that boards of directors and management have certain responsibilities for the ALLL process and amounts reported. For example, as indicated on page 4 of that statement, "the board of directors and management are expected to: Ensure that the institution has an effective loan review system and controls[;] Ensure the prompt charge-off of loans, or portions of loans, that available information confirms to be uncollectible[; and] Ensure that the institution's process for determining an adequate level for the ALLL is based on a comprehensive, adequately documented, and consistently applied analysis of the institution's loan and lease portfolio."

FN13 SAS 61 (as amended by SAS 90) states, in part: "In connection with each SEC engagement the auditor should discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the entity's accounting principles as applied in its financial reporting. The discussion should include items that have a significant impact on the representational faithfulness, verifiability, and neutrality of the accounting information included in the financial statements. [Footnote omitted.] Examples of items that may have such an impact are the following:

- Selection of new or changes to accounting policies
- Estimates, judgments, and uncertainties
- Unusual ~~trans~~transactions

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

A systematic methodology that is properly designed and implemented should result in a registrant's best estimate of its

allowance for loan losses. FN14 Accordingly, the staff normally would expect registrants to adjust their loan loss allowance balance, either upward or downward, in each period for differences between the results of the systematic determination process and the unadjusted loan loss allowance balance in the general ledger. FN15

FN14 Registrants should also refer to ~~Interpretation 14 (Topic 450)~~ FASB ASC Section 450-20-30, Contingencies—Loss Contingencies—Initial Measurement, which provides accounting and disclosure guidance for situations in which a range of loss can be reasonably estimated but no single amount within the range appears to be a better estimate than any other amount within the range.

FN15 Registrants should refer to the guidance on materiality in SAB Topic 1.M.

b. Documenting a systematic methodology.

Question 1: Assume the same facts as in the previous question in Section 2(a) Question 1. What would the staff normally expect Registrant A to include in its documentation of its loan loss allowance methodology?

Interpretive Response: In FRR 28, the Commission provided guidance for documentation of loan loss provisions and allowances for registrants engaged in lending activities. The staff believes that appropriate written supporting documentation for the loan loss provision and allowance facilitates review of the loan loss allowance process and reported amounts, builds discipline and consistency into the loan loss allowance determination process, and improves the process for estimating loan losses by helping to ensure that all relevant factors are appropriately considered in the allowance analysis.

The staff, therefore, normally would expect a registrant to document the relationship between the findings of its detailed review of the loan portfolio and the amount of the loan loss allowance and the provision for loan losses reported in each period. FN16

FN16 FRR 28 states: "The specific rationale upon which the [loan loss allowance and provision] amount actually

reported is based - i. e., the bridge between the findings of the detailed review [of the loan portfolio] and the amount actually reported in each period—would be documented to help ensure the adequacy of the reported amount, to improve auditability, and to serve as a benchmark for exercise of prudent judgment in future ~~periods, periods.~~"

The staff normally would expect to find that registrants maintain written supporting documentation for the following decisions, strategies, and processes: FN17

FN17 ~~Paragraph 7.39~~ Paragraph 9.64 in the Audit Guide outlines specific aspects of effective internal control related to the allowance for loan losses. These specific aspects include the control environment ("management communication of the need for proper reporting of the allowance"); management reports that summarize loan activity and the institution's procedures and controls ("accumulation of relevant, sufficient, and reliable data on which to base management's estimate of the allowance"); "independent loan review;" review of information and assumptions ("adequate review and approval of the allowance estimates by the individuals specified in management's written policy"); and assessment of the process ("comparison of prior estimates related to the allowance with subsequent results to assess the reliability of the process used to develop the allowance"); ~~and "consideration by management of whether the allowance is consistent with the operational plans of the institutional allowance").~~

Policies and procedures:

Over the systems and controls that maintain an appropriate loan loss allowance, and

Over the loan loss allowance methodology;

Loan grading system or process;

Summary or consolidation of the loan loss allowance balance;

Validation of the loan loss allowance methodology; and

Periodic adjustments to the loan loss allowance process.

Question 2: The Interpretive Response to Question 2 indicates that the staff normally would expect to find that registrants maintain written supporting documentation for their loan loss allowance policies and procedures. In the staff's view, what aspects of a registrant's loan loss allowance internal accounting control systems and processes would appropriately be addressed in its written policies and procedures?

Interpretive Response: The staff is aware that registrants utilize a wide range of policies, procedures, and control systems in their loan loss allowance processes, and these policies, procedures, and systems are tailored to the size and complexity of the registrant and its loan portfolio. However, the staff believes that, in order for a registrant's loan loss allowance methodology to be effective, the registrant's written policies and procedures for the systems and controls that maintain an appropriate loan loss allowance would likely address the following:

The roles and responsibilities of the registrant's departments and personnel (including the lending function, credit review, financial reporting, internal audit, senior management, audit committee, board of directors, and others, as applicable) who determine or review, as applicable, the loan loss allowance to be reported in the financial statements; FN18

~~FN18 Paragraph 7.39~~ Paragraph 9.64 of the Audit Guide discusses "management communication of the need for proper reporting of the allowance." As indicated in that paragraph, the "control environment strongly influences the effectiveness of the system of controls and reflects the overall attitude, awareness, and action of the board of directors and management concerning the importance of control."

The registrant's accounting policies for loans and loan losses, including the policies for charge-offs and recoveries and for estimating the fair value of collateral, where applicable; FN19

~~FN19 Paragraph 7.33~~ Paragraph 9.56 of the Audit Guide refers to the documentation, for disclosure purposes, that an entity should include in the notes to

the financial statements describing the accounting policies the entity used to estimate its allowance and related provision for loan losses.

The description of the registrant's systematic methodology, which should be consistent with the registrant's accounting policies for determining its loan loss allowance (see Question 4 below for further discussion); FN20 and

FN20 Ibid. As indicated in ~~paragraph 7.33~~paragraph 9.56, "[s]uch a description should identify the factors that influenced management's judgment (for example, historical losses and existing economic conditions) and may also include discussion of risk elements relevant to particular categories of financial instruments."

The system of internal controls used to ensure that the loan loss allowance process is maintained in accordance with GAAP. FN21

FN21 See also ~~paragraph 7.30~~paragraph 9.64 in the Audit Guide which provides information about specific aspects of effective internal control related to the allowance for loan losses.

The staff normally would expect an internal control system FN22 for the loan loss allowance estimation process to:

FN22 Ibid. Public companies are required to comply with the books and records provisions of the Exchange Act. Under Sections 13(b)(2) - (7) of the Exchange Act, registrants must make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of assets of the registrant. Registrants also must maintain internal accounting controls that are sufficient to provide reasonable assurances that, among other things, transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP.

Include measures to provide assurance regarding the reliability FN23 and integrity of information and compliance

with laws, regulations, and internal policies and procedures; FN24

FN23 Concepts ~~Statement 2~~Statement 2, *Qualitative Characteristics of Accounting Information*, provides guidance on "reliability" as a primary quality of accounting ~~information.~~information.

FN24 Section 13(b)(2) - (7) of the Exchange Act.

Reasonably assure that the registrant's financial statements are prepared in accordance with GAAP; and

Include a well-defined loan review process. FN25

FN25 As indicated in ~~paragraph 7.05~~paragraph 9.05, item a, in the Audit Guide, a loan loss allowance methodology should "include a detailed and regular analysis of the loan portfolio." ~~Paragraphs 7.06 to 7.13~~Paragraphs 9.06 to 9.13 provide additional information on how creditors traditionally identify and review loans on an individual basis and review or analyze loans on a group or pool basis.

A well-defined loan review process FN26 typically contains:

FN26 Ibid. Additionally, ~~paragraph 7.39~~paragraph 9.64 in the Audit Guide provides guidance on the loan review process. As stated in that paragraph, "[m]anagement reports summarizing loan activity, renewals, and delinquencies are vital to the timely identification of problem loans." The paragraph further states: "Loan reviews should be conducted by institution personnel who are independent of the underwriting, supervision, and collections functions. The specific lines of reporting depend on the complexity of the institution's organizational structure, but the loan reviewers should report to a high level of management that is independent from the lending process in the institution."

An effective loan grading system that is consistently applied, identifies differing risk characteristics and loan quality problems accurately and in a timely manner, and prompts appropriate administrative actions; FN27

FN27 Ibid.

Sufficient internal controls to ensure that all relevant loan review information is appropriately considered in estimating losses. This includes maintaining appropriate reports, details of reviews performed, and identification of personnel involved; FN28 and

FN28 Ibid.

Clear formal communication and coordination between a registrant's credit administration function, financial reporting group, management, board of directors, and others who are involved in the loan loss allowance determination or review process, as applicable (e. g., written policies and procedures, management reports, audit programs, and committee minutes). FN29

FN29 Ibid.

Question 3: The Interpretive Response to Question 3 indicates that the staff normally would expect a registrant's written loan loss allowance policies and procedures to include a description of the registrant's systematic allowance methodology, which should be consistent with its accounting policies for determining its loan loss allowance. What elements of a registrant's loan loss allowance methodology would the staff normally expect to be described in the registrant's written policies and procedures?

Interpretive Response: The staff normally would expect a registrant's written policies and procedures to describe the primary elements of its loan loss allowance methodology, including portfolio segmentation and impairment measurement. The staff normally would expect that, in order for a registrant's loan loss allowance methodology to be effective, the registrant's written policies and procedures would describe the methodology:

For segmenting the portfolio:

How the segmentation process is performed (i. e., by loan type, industry, risk rates, etc.); FN30

FN30 ~~Paragraph 7.07~~ Paragraph 9.07 in the Audit Guide states that "creditors have traditionally

identified loans that are to be evaluated for collectibility by dividing the loan portfolio into different segments. ~~Each segment should contain loans~~Loans with similar risk characteristics, such as risk classification, past-due status, and type of loan should be grouped together." ~~Paragraph 7.08~~Paragraph 9.08 provides additional guidance on classifying individual loans and ~~paragraph 7.13~~paragraph 9.13 indicates considerations for groups or pools of loans.

When a loan grading system is used to segment the portfolio:

The definitions of each loan grade;

A reconciliation of the internal loan grades to supervisory loan grades, if applicable; and

The delineation of responsibilities for the loan grading system.

For determining and measuring impairment under ~~Statement 114 [Topic 310]~~FASB ASC Subtopic 310-10: FN31

~~FN31 See Statement 114, paragraphs 8 through 10 [paragraphs 310-10-35-16 through 35-19]~~FASB ASC paragraphs 310-10-35-16 through 310-10-35-19 on recognition of impairment and paragraphs 11 through 16 [paragraphs 310-10-35-20 through 35-28]FASB ASC paragraphs 310-10-35-20 through 310-10-35-37 on measurement of impairment. See also the guidance in EITF Topic D-80 [Section 310-10-35].

The methods used to identify loans to be analyzed individually;

For individually reviewed loans that are impaired, how the amount of any impairment is determined and measured, including:

Procedures describing the impairment measurement techniques available; and

Steps performed to determine which technique is most appropriate in a given situation.

The methods used to determine whether and how loans individually evaluated under ~~Statement 114 [Topic 310]~~FASB ASC Subtopic 310-10, but not considered to be individually impaired, should be grouped with other loans that share common characteristics for impairment evaluation under ~~Statement 5 [Topic 450]~~FASB ASC Subtopic 450-20. FN32

FN32 See ~~EITF Topic D-80, Exhibit D-80A, Question #10 [paragraph 310-10-35-36]~~FASB ASC paragraph 310-10-35-36.

For determining and measuring impairment under ~~Statement 5 [Topic 450]~~FASB ASC Subtopic 450-20: FN33

FN33 See ~~Statement 5, paragraphs 8(a) and 8(b) [paragraph 450-20-25-2]~~FASB ASC paragraph 450-20-25-2 on accrual of loss contingencies and ~~paragraphs 22 and 23 [paragraphs 310-10-35-7 through 35-11]~~FASB ASC paragraphs 310-10-35-5 through 310-10-35-11 on collectibility of receivables. See also the guidance in ~~EITF Topic D-80 [Section 310-10-35]~~.

How loans with similar characteristics are grouped to be evaluated for loan collectibility (such as loan type, past-due status, and risk);

How loss rates are determined (e. g., historical loss rates adjusted for environmental factors or migration analysis) and what factors are considered when establishing appropriate time frames over which to evaluate loss experience; and

Descriptions of qualitative factors (e. g., industry, geographical, economic, and political factors) that may affect loss rates or other loss measurements.

3. Applying a systematic methodology - measuring and documenting loan losses under ~~Statement 114 [Topic 310]~~FASB ASC Subtopic 310-10

a. Measuring and documenting loan losses under ~~Statement 114 [Topic 310]~~ general FASB ASC Subtopic 310-10.

Facts: Approximately one-third of Registrant B's commercial loan portfolio consists of large balance, non-homogeneous loans. Due to their large individual balances, these loans meet the criteria under Registrant B's policies and procedures for individual review for impairment under ~~Statement 114 [Topic 310]~~ FASB ASC Subtopic 310-10.

Upon review of the large balance loans, Registrant B determines that certain of the loans are impaired as defined by ~~Statement 114 [Topic 310]~~ FASB ASC Subtopic 310-10. FN34

~~FN34 Paragraph 8 of Statement 114 [paragraph 310-10-35-16]~~ FASB ASC paragraph 310-10-35-8 provides that a loan is impaired when, based on current information and events, it is probable that all amounts due will not be collected pursuant to the terms of the loan agreement.

Question: ~~or~~ For the commercial loans reviewed under ~~Statement 114 [Topic 310]~~ FASB ASC Subtopic 310-10 that are individually impaired, how would the staff normally expect Registrant B to measure and document the impairment on those loans? Can it use an impairment measurement method other than the methods allowed by ~~Statement 114 [Topic 310]~~ FASB ASC Subtopic 310-10?

Interpretive Response: For those loans that are reviewed individually under ~~Statement 114 [Topic 310]~~ FASB ASC Subtopic 310-10 and considered individually impaired, Registrant B must use one of the methods for measuring impairment that is specified by ~~Statement 114 [Topic 310]~~ FASB ASC Subtopic 310-10 (that is, the present value of expected future cash flows, the loan's observable market price, or the fair value of collateral). FN35 Accordingly, in the circumstances described above, for the loans considered individually impaired under ~~Statement 114 [Topic 310]~~ FASB ASC Subtopic 310-10, it would not be appropriate for Registrant B to choose a measurement method not prescribed by ~~Statement 114 [Topic 310]~~ FASB ASC Subtopic 310-10. For example, it would not be appropriate to measure loan impairment by applying a loss rate to each loan based on the average historical loss percentage for all of its commercial loans for the past five years.

FN35 See ~~paragraph 13 of Statement 114 [paragraph 310-10-35-25]~~FASB ASC paragraph 310-10-35-22.

The staff normally would expect Registrant B to maintain as sufficient, objective evidence FN36 written documentation to support its measurement of loan impairment under ~~Statement 114 [Topic 310]~~FASB ASC Subtopic 310-10. FN37 If Registrant B uses the present value of expected future cash flows to measure impairment of a loan, it should document the amount and timing of cash flows, the effective interest rate used to discount the cash flows, and the basis for the determination of cash flows, including consideration of current environmental factors FN38 and other information reflecting past events and current conditions. If Registrant B uses the fair value of collateral to measure impairment, the staff normally would expect to find that Registrant B had documented how it determined the fair value, including the use of appraisals, valuation assumptions and calculations, the supporting rationale for adjustments to appraised values, if any, and the determination of costs to sell, if applicable, appraisal quality, and the expertise and independence of the appraiser. FN39 Similarly, the staff normally would expect to find that Registrant B had documented the amount, source, and date of the observable market price of a loan, if that method of measuring loan impairment is used.

FN36 Under GAAS, auditors should obtain "sufficient competent evidential matter" to support its audit opinion. See AU Section 326. The staff normally would expect registrants to maintain such evidential matter for its allowances for loan losses for use by the auditors in conducting their annual audit.

FN37 ~~Paragraph 7.45~~Paragraph 9.74 in the Audit Guide outlines sources of information, available from management, that the independent accountant should consider in identifying loans that contain high credit risk or other significant exposures and concentrations. These sources of information would also likely include documentation of loan impairment under ~~Statement 114 or Statement 5 [Topic 310 or Topic 450]~~FASB ASC Subtopic 310-10 or FASB ASC Subtopic 450-20. Additionally, as indicated in ~~paragraphs 7.56 to 7.68~~paragraphs 9.85 to 9.97 of the Audit Guide, the independent accountant, in conducting an audit, may perform a detailed loan file review for selected loans. A registrant's loan files may contain

documentation about borrowers' financial resources and cash flows (see ~~paragraph 7.63~~paragraph 9.92) or about the collateral securing the loans, if applicable (see ~~paragraphs 7.65 and 7.66~~paragraphs 9.94 and 9.95).

~~FN38 Question #16 in Exhibit D-80A of EITF Topic D-80 [paragraph 310-10-35-27]~~FASB ASC paragraph 310-10-35-27 indicates that environmental factors include existing industry, geographical, economic, and political factors.

~~FN39 See paragraphs 7.65 and 7.66~~paragraphs 9.94 and 9.95 in the Audit Guide for additional information about documentation of loan collateral.

b. Measuring and documenting loan losses under ~~Statement 114 [Topic 310]~~FASB ASC Subtopic 310-10 for a collateral dependent loan.

Facts: Registrant C has a \$10 million loan outstanding to Company X that is secured by real estate, which Registrant C individually evaluates under ~~Statement 114 [Topic 310]~~FASB ASC Subtopic 310-10 due to the loan's size. Company X is delinquent in its loan payments under the terms of the loan agreement. Accordingly, Registrant C determines that its loan to Company X is impaired, as defined by ~~Statement 114 [paragraph 310-10-35-16]~~FASB ASC Subtopic 310-10. Because the loan is collateral dependent, Registrant C measures impairment of the loan based on the fair value of the collateral. Registrant C determines that the most recent valuation of the collateral was performed by an appraiser eighteen months ago and, at that time, the estimated value of the collateral (fair value less costs to sell) was \$12 million.

Registrant C believes that certain of the assumptions that were used to value the collateral eighteen months ago do not reflect current market conditions and, therefore, the appraiser's valuation does not approximate current fair value of the collateral.

Several buildings, which are comparable to the real estate collateral, were recently completed in the area, increasing vacancy rates, decreasing lease rates, and attracting several tenants away from the borrower. Accordingly, credit review personnel at Registrant C adjust certain of the valuation assumptions to better reflect the current market conditions as

they relate to the loan's collateral. FN40 After adjusting the collateral valuation assumptions, the credit review department determines that the current estimated fair value of the collateral, less costs to sell, is \$8 million. FN41 Given that the recorded investment in the loan is \$10 million, Registrant C concludes that the loan is impaired by \$2 million and records an allowance for loan losses of \$2 million.

FN40 When reviewing collateral dependent loans, Registrant C may often find it more appropriate to obtain an updated appraisal to estimate the effect of current market conditions on the appraised value instead of internally estimating an adjustment.

FN41 An auditor who uses the work of a specialist, such as an appraiser, in performing an audit in accordance with GAAS should refer to the guidance in SAS 73 (AU Section 336).

Question: What documentation would the staff normally expect Registrant C to maintain to support its determination of the allowance for loan losses of \$2 million for the loan to Company X?

Interpretive Response: The staff normally would expect Registrant C to document that it measured impairment of the loan to Company X by using the fair value of the loan's collateral, less costs to sell, which it estimated to be \$8 million. FN42 This documentation FN43 should include the registrant's rationale and basis for the \$8 million valuation, including the revised valuation assumptions it used, the valuation calculation, and the determination of costs to sell, if applicable.

FN42 See ~~paragraphs 7.65 to 7.66~~paragraphs 9.94 to 9.95 in the Audit Guide for further information about documentation of loan collateral and associated audit procedures that may be performed by the independent accountant.

FN43 As stated in ~~paragraph 7.14~~paragraph 9.14 of the Audit Guide, "[t]he institution's conclusions about the appropriate amount [of loan impairment and approach for determination of the allowance for loan losses] should be well documented."

Because Registrant C arrived at the valuation of \$8 million by modifying an earlier appraisal, it should document its rationale and basis for the changes it made to the valuation assumptions that resulted in the collateral value declining from \$12 million eighteen months ago to \$8 million in the current period.

c. Measuring and documenting loan losses under ~~Statement 144~~  
~~Topic 310~~ FASB ASC Subtopic 310-10 - fully collateralized loans.

Question: In the staff's view, what is an example of an acceptable documentation practice for a registrant to adequately support its determination that no allowance for loan losses should be recorded for a group of loans because the loans are fully collateralized?

Interpretive Response: Consider the following fact pattern: Registrant D has \$10 million in loans that are fully collateralized by highly rated debt securities with readily determinable market values. The loan agreement for each of these loans requires the borrower to provide qualifying collateral sufficient to maintain a loan-to-value ratio with sufficient margin to absorb volatility in the securities' market prices. Registrant D's collateral department has physical control of the debt securities through safekeeping arrangements. In addition, Registrant D perfected its security interest in the collateral when the funds were originally distributed. On a quarterly basis, Registrant D's credit administration function determines the market value of the collateral for each loan using two independent market quotes and compares the collateral value to the loan carrying value. If there are any collateral deficiencies, Registrant D notifies the borrower and requests that the borrower immediately remedy the deficiency. Due in part to its efficient operation, Registrant D has historically not incurred any material losses on these loans. Registrant D believes these loans are fully-collateralized and therefore does not maintain any loan loss allowance balance for these loans.

Registrant D's management summary of the loan loss allowance includes documentation indicating that, in accordance with its loan loss allowance policy, the collateral protection on these loans has been verified by the registrant, no probable loss has been incurred, and no loan loss allowance is necessary.

Documentation in Registrant D's loan files includes the two independent market quotes obtained each quarter for each

loan's collateral amount, the documents evidencing the perfection of the security interest in the collateral, and other relevant supporting documents. Additionally, Registrant D's loan loss allowance policy includes a discussion of how to determine when a loan is considered "fully collateralized" and does not require a loan loss allowance. Registrant D's policy requires the following factors to be considered and its findings concerning these factors to be fully documented:

Volatility of the market value of the collateral;

Recency and reliability of the appraisal or other valuation;

Recency of the registrant's or third party's inspection of the collateral;

Historical losses on similar loans;

Confidence in the registrant's lien or security position including appropriate:

Type of security perfection (e. g., physical possession of collateral or secured filing);

Filing of security perfection (i. e., correct documents and with the appropriate officials); and

Relationship to other liens; and

Other factors as appropriate for the loan type.

In the staff's view, Registrant D's documentation supporting its determination that certain of its loans are fully collateralized, and no loan loss allowance should be recorded for those loans, is acceptable under FRR 28.

4. Applying a systematic methodology - measuring and documenting loan losses under ~~Statement 5 [Topic 450]~~FASB ASC Subtopic 450-20

a. Measuring and documenting loan losses under ~~Statement 5 [Topic 450]—general~~FASB ASC Subtopic 450-20.

Question 1: In the staff's view, what are some general considerations for a registrant in applying its systematic methodology to measure and document loan losses under Statement 5 [Topic 450] FASB ASC Subtopic 450-20?

Interpretive Response: For loans evaluated on a group basis under Statement 5 [Topic 450] FASB ASC Subtopic 450-20, the staff believes that a registrant should segment the loan portfolio by identifying risk characteristics that are common to groups of loans. FN44 Registrants typically decide how to segment their loan portfolios based on many factors, which vary with their business strategies as well as their information system capabilities. Regardless of the segmentation method used, the staff normally would expect a registrant to maintain documentation to support its conclusion that the loans in each segment have similar attributes or characteristics. As economic and other business conditions change, registrants often modify their business strategies, which may result in adjustments to the way in which they segment their loan portfolio for purposes of estimating loan losses. The staff normally would expect registrants to maintain documentation to support these segmentation adjustments. FN45

FN44 ~~Paragraph 7.07~~ Paragraph 9.07 of the Audit Guide indicates that "~~each segment [of the loan portfolio] should contain loans~~ loans with similar risk characteristics, such as risk classification, past-due status, and type of loan, should be grouped together."

FN45 Segmentation of the loan portfolio is a standard element in a loan loss allowance methodology. As indicated in ~~paragraph 7.05~~ paragraph 9.05 of the Audit Guide, the loan loss allowance methodology "should be well documented, with clear explanations of the supporting analyses and rationale."

Based on the segmentation of the loan portfolio, a registrant should estimate the Statement 5 [Topic 450] FASB ASC Subtopic 450-20 portion of its loan loss allowance. For those segments that require an allowance for loan losses, FN46 the registrant should estimate the loan losses, on at least a quarterly basis, based upon its ongoing loan review process and analysis of loan performance. FN47 The registrant should follow a systematic and consistently applied approach to select the most appropriate

loss measurement methods and support its conclusions and rationale with written documentation. FN48

FN46 An example of a loan segment that does not generally require an allowance for loan losses is a group of loans that are fully secured by deposits maintained at the lending institution.

FN47 FRR 28 refers to a "systematic methodology to be employed each period" in determining provisions and allowances for loan losses. As indicated in FRR 28, the staff normally would expect that the systematic methodology would be documented "to help ensure that all matters affecting loan collectibility will consistently be identified in the detailed [loan] review process."

FN48 Ibid. Also, as indicated in ~~paragraph 7.05~~paragraph 9.05 of the Audit Guide, the loan loss allowance methodology "should be well documented, with clear explanations of the supporting analyses and rationale." Further, as indicated in ~~paragraph 7.14~~paragraph 9.14 of the Audit Guide, "[t]he ~~institution's conclusions about the appropriate amount [of the allowance]~~approach for determination of the allowance should be well documented."

Facts: After identifying certain loans for evaluation under ~~Statement 114 [Topic 310]~~FASB ASC Subtopic 310-10, Registrant E segments its remaining loan portfolio into five pools of loans. For three of the pools, it measures loan impairment under ~~Statement 5 [Topic 450]~~FASB ASC Subtopic 450-20 by applying historical loss rates, adjusted for relevant environmental factors, to the pools' aggregate loan balances. For the remaining two pools of loans, Registrant E uses a loss estimation model that is consistent with GAAP to measure loan impairment under ~~Statement 5 [Topic 450]~~FASB ASC Subtopic 450-20.

Question 2: What documentation would the staff normally expect Registrant E to prepare to support its loan loss allowance for its pools of loans under ~~Statement 5 [Topic 450]~~FASB ASC Subtopic 450-20?

Interpretive Response: Regardless of the method used to determine loan loss measurements under ~~Statement 5 [Topic 450]~~FASB ASC 450-20, Registrant E should demonstrate and

document that the loss measurement methods used to estimate the loan loss allowance for each segment of its loan portfolio are determined in accordance with GAAP as of the financial statement date. FN49

~~FN49 Refer to paragraph 8(b) of Statement 5 [paragraph 450-20-25-2] FASB ASC paragraph 450-20-25-2(b). Also, as indicated in Exhibit D-80A of EITF Topic D-80 [paragraph 310-10-35-4] FASB ASC paragraph 310-10-35-4(c), "[t]he approach for determination of the allowance shouldshall be well documented and applied consistently from period to period." (See the overview section of Exhibit D-80A and Question #18.)~~

As indicated for Registrant E, one method of estimating loan losses for groups of loans is through the application of loss rates to the groups' aggregate loan balances. Such loss rates typically reflect the registrant's historical loan loss experience for each group of loans, adjusted for relevant environmental factors (e. g., industry, geographical, economic, and political factors) over a defined period of time. If a registrant does not have loss experience of its own, it may be appropriate to reference the loss experience of other companies in the same business, provided that the registrant demonstrates that the attributes of the loans in its portfolio segment are similar to those of the loans included in the portfolio of the registrant providing the loss experience. FN50 Registrants should maintain supporting documentation for the technique used to develop their loss rates, including the period of time over which the losses were incurred. If a range of loss is determined, registrants should maintain documentation to support the identified range and the rationale used for determining which estimate is the best estimate within the range of loan losses. FN51

~~FN50 Refer to paragraph 23 of Statement 5 [paragraph 310-10-35-10] FASB ASC paragraphs 310-10-35-10 through 310-10-35-11.~~

~~FN51 Registrants should also refer to Interpretation 14 [Topic 450] FASB ASC Subtopic 450-20, which provides guidance for situations in which a range of loss can be reasonably estimated but no single amount within the range appears to be a better estimate than any other amount within the range. Also, paragraph 7.14 [paragraph 9.14] of the Audit Guide notes the use of "a method that~~

results in a range of estimates for the allowance," except for impairment measurement under ~~Statement 114~~FASB ASC Subtopic 310-10, which is based on ~~aa single best estimate and not a range of estimates.~~estimates. ~~Paragraph 7.14~~Paragraph 9.14 also states that "[t]he institution's ~~conclusions about the appropriate amount~~approach for determination of the allowance should be well documented."

The staff normally would expect that, before employing a loss estimation model, a registrant would evaluate and modify, as needed, the model's assumptions to ensure that the resulting loss estimate is consistent with GAAP. In order to demonstrate consistency with GAAP, registrants that use loss estimation models should typically document the evaluation, the conclusions regarding the appropriateness of estimating loan losses with a model or other loss estimation tool, and the objective support for adjustments to the model or its results. FN52

FN52 The systematic methodology (including, if applicable, loss estimation models) used to determine loan loss provisions and allowances should be documented in accordance with FRR 28, ~~paragraph 7.05~~paragraph 9.05 of the Audit Guide, and ~~EITF Topic D-80 [Topic 310]~~FASB ASC Subtopic 310-10.

In developing loss measurements, registrants should consider the impact of current environmental factors and then document which factors were used in the analysis and how those factors affected the loss measurements. Factors that should be considered in developing loss measurements include the following: FN53

FN53 Refer to ~~paragraph 7.13~~paragraph 9.13 in the Audit Guide.

Levels of and trends in delinquencies and impaired loans;

Levels of and trends in charge-offs and recoveries;

Trends in volume and terms of loans;

Effects of any changes in risk selection and underwriting standards, and other changes in lending policies, procedures, and practices;

Experience, ability, and depth of lending management and other relevant staff;

National and local economic trends and conditions;

Industry conditions; and

Effects of changes in credit concentrations.

For any adjustment of loss measurements for environmental factors, a registrant should maintain sufficient, objective evidence FN54 (a) to support the amount of the adjustment and (b) to explain why the adjustment is necessary to reflect current information, events, circumstances, and conditions in the loss measurements.

FN54 AU 326 describes the "sufficient competent evidential matter" that auditors must consider in accordance with GAAS.

b. Measuring and documenting loan losses under ~~Statement 5~~ FASB ASC Subtopic 450-20 - adjusting loss rates.

Facts: Registrant F's lending area includes a metropolitan area that is financially dependent upon the profitability of a number of manufacturing businesses. These businesses use highly specialized equipment and significant quantities of rare metals in the manufacturing process. Due to increased low-cost foreign competition, several of the parts suppliers servicing these manufacturing firms declared bankruptcy. The foreign suppliers have subsequently increased prices and the manufacturing firms have suffered from increased equipment maintenance costs and smaller profit margins.

Additionally, the cost of the rare metals used in the manufacturing process increased and has now stabilized at double last year's price. Due to these events, the manufacturing businesses are experiencing financial difficulties and have recently announced downsizing plans.

Although Registrant F has yet to confirm an increase in its loss experience as a result of these events, management knows that it lends to a significant number of businesses and individuals whose repayment ability depends upon the long-term viability of the manufacturing businesses. Registrant F's management has identified particular segments of its commercial and consumer customer bases that include borrowers highly dependent upon sales or salary from the manufacturing businesses. Registrant F's management performs an analysis of the affected portfolio segments to adjust its historical loss rates used to determine the loan loss allowance. In this particular case, Registrant F has experienced similar business and lending conditions in the past that it can compare to current conditions.

Question: How would the staff normally expect Registrant F to document its support for the loss rate adjustments that result from considering these manufacturing firms' financial downturns?  
FN55

FN55 This question and response would also apply to other registrant fact patterns in which the registrant adjusts loss rates for environmental factors.

Interpretive Response: The staff normally would expect Registrant F to document its identification of the particular segments of its commercial and consumer loan portfolio for which it is probable that the manufacturing business' financial downturn has resulted in loan losses. In addition, the staff normally would expect Registrant F to document its analysis that resulted in the adjustments to the loss rates for the affected portfolio segments. FN56 The staff normally would expect that, as part of its documentation, Registrant F would maintain copies of the documents supporting the analysis, which may include relevant economic reports, economic data, and information from individual borrowers.

FN56 ~~Paragraph 7.33~~ Paragraph 9.56 of the Audit Guide refers to the documentation, for disclosure purposes, that an entity should include in the notes to the financial statements describing the accounting policies and methodology the entity used to estimate its allowance and related provision for loan losses. As indicated in ~~paragraph 7.33~~ paragraph 9.56, "[s]uch a description should identify the factors that influenced management's judgment (for example, historical losses and existing economic

conditions) and may also include discussion of risk elements relevant to particular categories of financial instruments."

Because in this case Registrant F has experienced similar business and lending conditions in the past, it should consider including in its supporting documentation an analysis of how the current conditions compare to its previous loss experiences in similar circumstances. The staff normally would expect that, as part of Registrant F's effective loan loss allowance methodology, it would create a summary of the amount and rationale for the adjustment factor for review by management prior to the issuance of the financial statements. FN57

FN57 ~~Paragraph 7.39~~Paragraph 9.64 in the Audit Guide indicates that effective internal control related to the allowance for loan losses should include "accumulation of relevant, sufficient, and reliable data on which to base management's estimate of the allowance."

c. Measuring and documenting loan losses under ~~Statement 5 [Topic 450]~~FASB ASC Subtopic 450-20 estimating losses on loans individually reviewed for impairment but not considered individually impaired.

Facts: Registrant G has outstanding loans of \$2 million to Company Y and \$1 million to Company Z, both of which are paying as agreed upon in the loan documents. The registrant's loan loss allowance policy specifies that all loans greater than \$750,000 must be individually reviewed for impairment under ~~Statement 114 [Topic 310]~~FASB ASC Subtopic 310-10. Company Y's financial statements reflect a strong net worth, good profits, and ongoing ability to meet debt service requirements. In contrast, recent information indicates Company Z's profitability is declining and its cash flow is tight. Accordingly, this loan is rated substandard under the registrant's loan grading system. Despite its concern, management believes Company Z will resolve its problems and determines that neither loan is individually impaired as defined by ~~Statement 114 [paragraph 340-10-35-16]~~FASB ASC Subtopic 310-10.

Registrant G segments its loan portfolio to estimate loan losses under ~~Statement 5 [Topic 450]~~FASB ASC Subtopic 450-20. Two of its loan portfolio segments are Segment 1 and Segment 2. The loan to Company Y has risk characteristics similar to the

loans included in Segment 1 and the loan to Company Z has risk characteristics similar to the loans included in Segment 2. FN58

FN58 These groups of loans do not include any loans that have been individually reviewed for impairment under ~~Statement 114 [Topic 310]~~FASB ASC Section 310-10-35, Receivables—Overall—Subsequent Measurement, and determined to be impaired as defined by ~~Statement 114 [paragraph 310-10-35-16]~~FASB ASC Section 310-10-35.

In its determination of its loan loss allowance under ~~Statement 5 [Topic 450]~~FASB ASC Subtopic 450-20, Registrant G includes its loans to Company Y and Company Z in the groups of loans with similar characteristics (i. e., Segment 1 for Company Y's loan and Segment 2 for Company Z's loan). FN59 Management's analyses of Segment 1 and Segment 2 indicate that it is probable that each segment includes some losses, even though the losses cannot be identified to one or more specific loans. Management estimates that the use of its historical loss rates for these two segments, with adjustments for changes in environmental factors, provides a reasonable estimate of the registrant's probable loan losses in these segments.

FN59 ~~Question #10 in Exhibit D-80A of EITF Topic D-80 [paragraph 310-10-35-36]~~FASB ASC paragraph 310-10-35-36 states that if a creditor concludes that an individual loan specifically identified for evaluation is not impaired under ~~Statement 114 [Topic 310]~~FASB ASC Subtopic 310-10, that loan may be included in the assessment of the allowance for loan losses under ~~Statement 5 [Topic 450]~~FASB ASC Subtopic 450-20, but only if specific characteristics of the loan indicate that it is probable that there would be an incurred loss in a group of loans with those characteristics.

Question: How would the staff normally expect Registrant G to adequately document a loan loss allowance under ~~Statement 5 [Topic 450]~~FASB ASC Subtopic 450-20 for these loans that were individually reviewed for impairment but are not considered individually impaired?

Interpretive Response: The staff normally would expect that, as part of Registrant G's effective loan loss allowance methodology, it would document its decision to include its loans to Company Y and Company Z in its determination of its loan loss allowance

under ~~Statement 5~~ FASB ASC Subtopic 450-20. FN60 The staff also normally would expect that Registrant G would document the specific characteristics of the loans that were the basis for grouping these loans with other loans in Segment 1 and Segment 2, respectively. FN61 Additionally, the staff normally would expect Registrant G to maintain documentation to support its method of estimating loan losses for Segment 1 and Segment 2, which typically would include the average loss rate used, the analysis of historical losses by loan type and by internal risk rating, and support for any adjustments to its historical loss rates. FN62 The registrant would typically maintain copies of the economic and other reports that provided source data.

~~FN60 Paragraph 7.05~~ Paragraph 9.05 in the Audit Guide indicates that an entity's method of estimating credit losses should "include a detailed and regular analysis of the loan portfolio," "consider all loans (whether on an individual or pool-of-loans basis)," "be based on current and reliable data," and "be well documented, with clear explanations of the supporting analyses and rationale." ~~Question #10 in Exhibit D-80A of EITF Topic D-80 (paragraph 310-10-35-36)~~ FASB ASC paragraph 310-10-35-36 provides guidance as to the analysis to be performed when determining whether a loan that is not individually impaired under ~~Statement 114~~ [Topic 310] FASB ASC Subtopic 310-10 should be included in the assessment of the loan loss allowance under ~~Statement 5~~ [Topic 450] FASB ASC Subtopic 450-20.

FN61 Ibid.

FN62 Ibid.

When measuring and documenting loan losses, Registrant G should take steps to prevent layering loan loss allowances. Layering is the inappropriate practice of recording in the allowance more than one amount for the same probable loan loss. Layering can happen when a registrant includes a loan in one segment, determines its best estimate of loss for that loan either individually or on a group basis (after taking into account all appropriate environmental factors, conditions, and events), and then includes the loan in another group, which receives an additional loan loss allowance amount.

## 5. Documenting the results of a systematic methodology

a. Documenting the results of a systematic methodology - general.

Facts: Registrant H has completed its estimation of its loan loss allowance for the current reporting period, in accordance with GAAP, using its established systematic methodology.

Question: What summary documentation would the staff normally expect Registrant H to prepare to support the amount of its loan loss allowance to be reported in its financial statements?

Interpretive Response: The staff normally would expect that, to verify that loan loss allowance balances are presented fairly in accordance with GAAP and are auditable, management would prepare a document that summarizes the amount to be reported in the financial statements for the loan loss allowance. FN63  
Common elements that the staff normally would expect to find documented in loan loss allowance summaries include: FN64

FN63 FRR 28 states: "[t]he specific rationale upon which the [loan loss allowance and provision] amount actually reported is based-i. e., the bridge between the findings of the detailed review [of the loan portfolio] and the amount actually reported in each period-would be documented to help ensure the adequacy of the reported amount, to improve auditability, and to serve as a benchmark for exercise of prudent judgment in future periods."

FN64 See also ~~paragraph 7.14~~paragraph 9.14 of the Audit Guide.

The estimate of the probable loss or range of loss incurred for each category evaluated (e. g., individually evaluated impaired loans, homogeneous pools, and other groups of loans that are collectively evaluated for impairment);

The aggregate probable loss estimated using the registrant's methodology;

A summary of the current loan loss allowance balance;

The amount, if any, by which the loan loss allowance balance is to be adjusted; FN65 and

FN65 Subsequent to adjustments, the staff normally would expect that there would be no material differences between the consolidated loss estimate, as determined by the methodology, and the final loan loss allowance balance reported in the financial statements. Registrants should refer to ~~SAB Topic 4-MSAB 99~~ and SAS 89 and ~~their~~ amendments to AU Section 310.

Depending on the level of detail that supports the loan loss allowance analysis, detailed subschedules of loss estimates that reconcile to the summary schedule.

Generally, a registrant's review and approval process for the loan loss allowance relies upon the data provided in these consolidated summaries. There may be instances in which individuals or committees that review the loan loss allowance methodology and resulting allowance balance identify adjustments that need to be made to the loss estimates to provide a better estimate of loan losses. These changes may be due to information not known at the time of the initial loss estimate (e. g., information that surfaces after determining and adjusting, as necessary, historical loss rates, or a recent decline in the marketability of property after conducting a ~~Statement 114 (Topic 310)~~ FASB ASC Subtopic 310-10 valuation based upon the fair value of collateral). It is important that these adjustments are consistent with GAAP and are reviewed and approved by appropriate personnel. FN66 Additionally, it would typically be appropriate for the summary to provide each subsequent reviewer with an understanding of the support behind these adjustments. Therefore, the staff normally would expect management to document the nature of any adjustments and the underlying rationale for making the changes. FN67

FN66 ~~Paragraph 7.39~~ Paragraph 9.64 in the Audit Guide indicates that effective internal control related to the allowance for loan losses should include "adequate review and approval of the allowance estimates by the individuals specified in management's written policy."

FN67 See the guidance in ~~paragraph 7.14~~ paragraph 9.14 of the Audit Guide ("the institution's conclusions about the appropriate amount" [t]he approach for determination of the allowance should be well documented") and in FRR 28 ("he the specific rationale upon which the amount actually

reported in each individual period is based would be documented").

The staff also normally would expect this documentation to be provided to those among management making the final determination of the loan loss allowance amount. FN68

FN68 Ibid.

b. Documenting the results of a systematic ~~methodology~~methodology—allowance adjustments.

Facts: Registrant I determines its loan loss allowance using an established systematic process. At the end of each reporting period, the accounting department prepares a summary schedule that includes the amount of each of the components of the loan loss allowance, as well as the total loan loss allowance amount, for review by senior management, including the Credit Committee. Members of senior management meet to discuss the loan loss allowance. During these discussions, they identify changes that are required by GAAP to be made to certain of the loan loss allowance estimates. As a result of the adjustments made by senior management, the total amount of the loan loss allowance changes. However, senior management (or its designee) does not update the loan loss allowance summary schedule to reflect the adjustments or reasons for the adjustments. When performing their audit of the financial statements, the independent accountants are provided with the original loan loss allowance summary schedule reviewed by senior management, as well as a verbal explanation of the changes made by senior management when they met to discuss the loan loss allowance.

Question: In the staff's view, are Registrant I's documentation practices related to the balance of its loan loss allowance in compliance with existing documentation guidance in this area?

Interpretive Response: No. A registrant should maintain supporting documentation for the loan loss allowance amount reported in its financial statements. FN69 As illustrated above, there may be instances in which loan loss allowance reviewers identify adjustments that need to be made to the loan loss estimates. The staff normally would expect the nature of the adjustments, how they were measured or determined, and the underlying rationale for making the changes to the loan loss

allowance balance to be documented. FN70 The staff also normally would expect appropriate documentation of the adjustments to be provided to management for review of the final loan loss allowance amount to be reported in the financial statements. This documentation should also be made available to the independent accountants. If changes frequently occur during management or credit committee reviews of the loan loss allowance, management may find it appropriate to analyze the reasons for the frequent changes and to reassess the methodology the registrant uses. FN71

FN69 Ibid.

FN70 Ibid.

FN71 As outlined in ~~paragraph 7.39~~paragraph 9.64 of the Audit Guide, effective internal controls related to the allowance for loan losses should include adequate review and approval of allowance estimates, including review of sources of relevant information, review of development of assumptions, review of reasonableness of assumptions and resulting estimates, and consideration of changes in previously established methods to arrive at the allowance.

## 6. Validating a systematic methodology

Question: What is the staff's guidance to a registrant on validating, and documenting the validation of, its systematic methodology used to estimate loan loss allowances?

Interpretive Response: The staff believes that a registrant's loan loss allowance methodology is considered valid when it accurately estimates the amount of loss contained in the portfolio. Thus, the staff normally would expect the registrant's methodology to include procedures that adjust loan loss estimation methods to reduce differences between estimated losses and actual subsequent charge-offs, as necessary. To verify that the loan loss allowance methodology is valid and conforms to GAAP, the staff believes it is appropriate for management to establish internal control policies, FN72 appropriate for the size of the registrant and the type and complexity of its loan products. These policies may include procedures for a review, by a party who is independent of the allowance for loan losses estimation process, of the allowance for loan losses methodology and its application in order to confirm its effectiveness.

FN72 Ibid.

In practice, registrants employ numerous procedures when validating the reasonableness of their loan loss allowance methodology and determining whether there may be deficiencies in their overall methodology or loan grading process. Examples are:

A review of trends in loan volume, delinquencies, restructurings, and concentrations.

A review of previous charge-off and recovery history, including an evaluation of the timeliness of the entries to record both the charge-offs and the recoveries.

A review by a party that is independent of the loan loss allowance estimation process. This often involves the independent party reviewing, on a test basis, source documents and underlying assumptions to determine that the established methodology develops reasonable loss estimates.

An evaluation of the appraisal process of the underlying collateral. This may be accomplished by periodically comparing the appraised value to the actual sales price on selected properties sold.

It is the staff's understanding that, in practice, management usually supports the validation process with the workpapers from the loan loss allowance review function. Additional documentation often includes the summary findings of the independent reviewer. The staff normally would expect that, if the methodology is changed based upon the findings of the validation process, documentation that describes and supports the changes would be maintained. FN73

FN73 See ~~paragraph 7.39~~ paragraph 9.64 of the Audit Guide.

9. Amend paragraph 320-10-S99-1, with no link to a transition paragraph, as follows:

## **Investments—Debt and Equity Securities—Overall**

### **SEC Materials**

#### **> SEC Staff Guidance**

> > Staff Accounting Bulletins

> > > SAB Topic 5.M, Other ~~than~~ Than Temporary Impairment of Certain Investments in Equity Securities

**320-10-S99-1** The following is the text of SAB Topic 5.M, Other ~~than~~ Than Temporary Impairment of Certain Investments in Equity Securities.

~~Facts: FASB Staff Position No. FAS 115-2 and FAS 124-2, Recognition and Presentation of Other Than Temporary Impairments ("FSP 115-2") [Topic 320] 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. ~~FN12~~FN8

~~FN12 FASB Staff Position No. FAS 115-1 and FAS 124-1, The Meaning of Other Than Temporary Impairment and Its Application to Certain Investments refers to this SAB for a discussion of considerations applicable to a determination as to whether a decline in market value below cost of an equity security, at a particular point in time, is other than temporary. FN8 [Original footnote removed by SAB 114.]~~

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.

10. Amend paragraphs 323-10-S99-1 through S99-2, with no link to a transition paragraph, as follows:

## **Investments—Equity Method and Joint Ventures—Overall**

### **SEC Materials**

#### **> SEC Staff Guidance**

#### **> > Staff Accounting Bulletins**

#### **> > > SAB Topic 6.K.3, Undistributed Earnings of 50% or Less Owned Persons**

**323-10-S99-1** The following is the text from SAB Topic 6.K.3, Undistributed Earnings of 50% or Less Owned Persons.

Facts: Rule 4-08(e)(2) of Regulation SX requires footnote disclosures of the amount of consolidated retained earnings which represents undistributed earnings of 50% or less owned persons (investee) accounted for by the equity method. The test adopted in ASR 302 to trigger disclosures about the registrant's restricted net assets (Rule 4-08(e)(3)) includes the parent's equity in the undistributed earnings of investees.

Question: Is the amount required for footnote disclosure the same as the amount included in the test to determine disclosures about restrictions?

Interpretive Response: Yes. The amount used in the test in Rule 4-08(e)(3) should be the same as the amount required to be disclosed by Rule 4-08(e)(2). This is the portion of the registrant's consolidated retained earnings which represents the undistributed earnings of an investee since the date(s) of acquisition. It is computed by determining the registrant's cumulative equity in the investee's earnings, adjusted by any dividends received, related goodwill ~~amortized~~ write-downs, and any related income taxes provided.

**> > > SAB Topic 6.K.4.b, Application of Significant Subsidiary Test to Investees and Unconsolidated Subsidiaries**

**323-10-S99-2** The following is the text of SAB Topic 6.K.4.b, Application of Significant Subsidiary Test to Investees and Unconsolidated Subsidiaries.

b. Summarized financial statement requirements.

Facts: Rule 4-08(g) of Regulation S-X requires summarized financial information about unconsolidated subsidiaries and 50% or less owned persons (investee) to be included in the footnotes to the financial statements if, in the aggregate, they meet the tests of a significant subsidiary set forth in Rule 1-02(w).

Question 1: Must a registrant which includes separate financial statements or condensed financial statements for unconsolidated subsidiaries or investees in its annual report to shareholders also include in such report the summarized financial information for these entities pursuant to Rule 4-08(g)?

Interpretive Response: No. The purpose of the summarized information is to provide minimum standards of disclosure when the impact of such entities on the consolidated financial statements is significant. If the registrant furnishes more information in the annual report than is required by these minimum disclosure standards, such as condensed financial information or separate audited financial statements, the summarized data can be

excluded. The Commission's rules are not intended to conflict with the provisions of FASB ASC subparagraph 323-10-50-3(c) (Investments—Equity Method and Joint Ventures Topic) ~~APB Opinion 18, par 20(c) and (d) [paragraph 323-10-50-3]~~, which provide that either separate financial statements of investees be presented with the financial statements of the reporting entity or that summarized information be included in the reporting entity's financial statement footnotes.

Question 2: Can summarized information be omitted for individual entities as long as the aggregate information for the omitted entity(s) does not exceed 10% under any of the significance tests of Rule 1-02(w)?

Interpretive Response: The 10% measurement level of the significant subsidiary rule was not intended to establish a materiality criteria for omission, and the arbitrary exclusion of summarized information for selected entities up to a 10% level is not appropriate. Rule 4-08(g) requires that the summarized information be included for all unconsolidated subsidiaries and investees. However, the staff recognizes that exclusion of the summarized information for certain entities is appropriate in some circumstances where it is impracticable to accumulate such information and the summarized information to be excluded is de minimis.

11. Amend paragraphs 330-10-S99-1 through S99-2, with no link to a transition paragraph, as follows:

## **Inventory—Overall**

### **SEC Materials**

#### **> SEC Staff Guidance**

#### **> > Staff Accounting Bulletins**

#### **> > > SAB Topic 5.L, LIFO Inventory Practices**

**330-10-S99-1** The following is the text of SAB Topic 5.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. FN11 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.

FN11 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..."

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, ~~APB Opinion 20 [Subtopic 250-10]~~ 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.

### >>> SAB Topic 5.BB, Inventory Valuation Allowance

**330-10-S99-2** The following is the text of SAB Topic 5.BB, Inventory Valuation Allowance.

Facts: ~~ARB 43, Chapter 4, Statement 5 [paragraph 330-10-35-1]~~ 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 ~~should~~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."

~~Footnote 2 to that same chapter~~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 period, such reduced amount is to be considered the cost for subsequent accounting purposes."

Lastly, ~~Opinion 20~~the FASB ASC Master Glossary provides "inventory obsolescence" as one of the items subject to ~~estimation and changes in estimates under the guidance in paragraphs 10-11 and 31-33 of that Opinion~~a change in accounting estimate.

Question: Does the write-down of inventory to the lower of cost or market, as required by ~~ARB 43 [Section 330-10-35]~~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 ~~ARB 43, footnote 2~~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. ~~FN68~~FN59

~~FN68~~FN59 See also disclosure requirement for inventory balances in Rule 5-02(6) of Regulation S-X.

12. Amend paragraph 340-10-S99-2, with no link to a transition paragraph, as follows:

**Other Assets and Deferred Costs—Overall**

**SEC Materials**

**> SEC Staff Guidance**

**> > Staff Accounting Bulletins**

**> > > SAB Topic 2.A.6, Debt Issue Costs in Conjunction with a Business Combination**

**340-10-S99-2** The following is the text of SAB Topic 2.A.6, Debt Issue Costs in Conjunction with a Business Combination.

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, Statement 141(R) (Topic 805) 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?

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, consensus reached in EITF Issue 86-15 (Subtopic 470-10) should be followed. FN1

FN1 As noted in FASB ASC paragraph 470-10-35-2, the "Status" ~~section of the Abstract to Issue 86-15~~, the term-extending provisions of the debt instrument should be analyzed to determine whether they constitute an embedded derivative requiring separate accounting in accordance with FASB ASC Topic 815, Derivatives and Hedging, Statement 133 (as amended). (~~Paragraph 470-10-35-2~~)

13. Amend paragraph 360-10-S99-2, with no link to a transition paragraph, as follows:

**Property, Plant, and Equipment—Overall**

**SEC Materials**

**> SEC Staff Guidance**

**> > Staff Accounting Bulletins**

**> > > SAB Topic 5.CC, Impairments**

**360-10-S99-2** The following is the text of SAB Topic 5.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, Statement 144 [Section 360-10-35]. 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, Statement 142 [Section 350-30-35].

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 Statement 144 [Subtopic 360-10] 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 Statement 144 [Subtopic 360-10] to classify the mainframe computer assets as "to be abandoned?"

Interpretive Response: No. FASB ASC paragraph 360-10-35-47 Statement 144, paragraph 28 [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, Opinion 20 [Subtopic 250-10] 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 Statement 144 [Subtopic 360-10] 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 ~~For an asset that meets the requirements to be classified as "held for sale" under Statement 144, paragraph 34 [paragraph 360-10-35-43] of that standard~~ 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 Statement 144 [Subtopic 360-10], an assessment must first be made as to whether the asset (asset group) is impaired. FASB ASC paragraph 360-10-35-17 Paragraph 7 of Statement 144 [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, Statement 144 [Subtopic 360-10].

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? Statement 144 [Subtopic 360-10]?

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 Statement 144, paragraph 17 [paragraph 360-10-35-30] of that Statement indicates that "estimates of future cash flows used to test the recoverability of a long-lived asset (asset group) shall incorporate the entity's own assumptions about its use of the asset (asset group) and shall consider all available evidence. The assumptions used in developing those estimates shall be reasonable in relation to the assumptions used in developing other information used by the entity for comparable periods, such as internal budgets and projections, accruals related to incentive compensation plans, or information communicated to others."

The staff recognizes that various factors, including management's judgments and assumptions about the business plans and strategies, affect the development of future cash flow projections for purposes of applying FASB ASC Topic 360, Statement 144 [Subtopic 360-10]. The staff, however, cautions registrants that the judgments and assumptions made for purposes of applying FASB ASC Topic 360, Statement 144 must be consistent with other financial statement calculations and disclosures and disclosures in MD&A. The staff also expects that forecasts made for purposes of applying FASB ASC Topic 360, Statement 144 [Subtopic 360-10] 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, Statement 144 [Subtopic 360-10] 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, Statement 109 [Section 740-10-30]. 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.

14. Amend paragraphs 420-10-S99-1 through S99-2, with no link to a transition paragraph, as follows:

## **Exit or Disposal Cost Obligations—Overall**

### **SEC Materials**

#### **> SEC Staff Guidance**

#### **> > Staff Accounting Bulletins**

#### **> > > SAB Topic 5.P, Restructuring Charges**

**> > > SAB Topic 5.P.3, Income Statement Presentation of Restructuring Charges**

**420-10-S99-1** The following is the text of SAB Topic 5.P.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 FN15 they are not presented in the income statement as extraordinary items.

FN15 See FASB ASC paragraph 225-20-45-2. ~~APB Opinion 30, paragraph 20 [paragraph 225-20-45-2].~~

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). ~~Paragraph 26 of APB Opinion 30 [paragraph 225-20-45-16]~~ 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. FN16 Neither FASB ASC Subtopic 225-20, Income Statement—Extraordinary and Unusual Items, ~~Opinion 30 [Subtopic 225-20]~~ 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. ~~Opinion 30 [Subtopic 225-20].~~

FN16 FASB ASC paragraph 225-20-45-16. ~~Paragraph 26 of APB Opinion 30 [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.

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.

#### >>> **SAB Topic 5.P.4, Disclosures**

**420-10-S99-2** The following is the text of SAB Topic 5.P.4, Disclosures.

Beginning with the period in which the exit plan is initiated, FASB ASC Topic 420, Exit or Disposal Cost Obligations, Statement 146 [Section 420-10-50] requires disclosure, in all periods, including interim periods, until the exit plan is completed, of the following:

- a. A description of the exit or disposal activity, including the facts and circumstances leading to the expected activity and the expected completion date.
- b. For each major type of cost associated with the activity (for example, one-time termination benefits, contract termination costs, and other associated costs):
  - (1) The total amount expected to be incurred in connection with the activity, the amount incurred in the period, and the cumulative amount incurred to date.
  - (2) A reconciliation of the beginning and ending liability balances showing separately the changes during the period attributable to costs incurred and charged to expense, costs paid or otherwise settled, and any adjustments to the liability with an explanation of the reason(s) therefor.
- c. The line item(s) in the income statement or the statement of activities in which the costs in (b) above are aggregated.
- d. For each reportable segment, the total amount of costs expected to be incurred in connection with the activity, the amount incurred in the period, and the cumulative amount incurred to date, net of any

adjustments to the liability with an explanation of the reason(s) therefor.

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

Question: What specific disclosures about restructuring charges has the staff requested to fulfill the disclosure requirements of FASB ASC Topic 420 ~~Statement 146~~ ~~[Subtopic 420-10]~~ 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 FN17 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.

FN17 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 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 FN18 (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.

FN18 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, Statement 88, 112, or 146 [Subtopics 715-30, 712-10 or 420-10].

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.).

15. Amend paragraph 450-20-S99-1, with no link to a transition paragraph, as follows:

## **Contingencies—Loss Contingencies**

### **SEC Materials**

#### **> SEC Staff Guidance**

#### **> > Staff Accounting Bulletins**

#### **> > > SAB Topic 5.Y, Accounting and Disclosures Relating to Loss Contingencies**

**450-20-S99-1** The following is the text of SAB Topic 5.Y, Accounting and Disclosures Relating to Loss Contingencies.

Facts: A registrant believes it may be obligated to pay material amounts as a result of product or environmental remediation liability. These amounts may relate to, for example, damages attributed to the registrant's products or processes, clean-up of hazardous wastes, reclamation costs, fines, and litigation costs. The registrant may seek to recover a portion or all of these amounts by filing a claim against an insurance carrier or other third parties.

Question 1: Assuming that the registrant's estimate of an environmental remediation or product liability meets the conditions set forth in ~~paragraph 132 of SOP 96-1 [paragraph 410-30-35-12]~~ 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. ~~SOP 96-1 further states that~~ Further, the discount rate used to discount the cash payments should not exceed the interest rate on monetary assets that are essentially risk free ~~FN57FN48~~ and have maturities comparable to that of the environmental or product liability.

FN57FN48 As described in Concepts Statement 77, *Using Cash Flow Information and Present Value in Accounting Measurements*.

If the liability is recognized on a discounted basis to reflect the time value of money, the notes to the financial statements should, at a minimum, include disclosures of the discount rate used, the expected aggregate undiscounted amount, expected payments for each of the five succeeding years and the aggregate amount thereafter, and a reconciliation of the expected aggregate undiscounted amount to amounts recognized in the statements of financial position. Material changes in the expected aggregate amount since the prior balance sheet date, other than those resulting from pay-down of the obligation, should be explained.

Question 2: What financial statement disclosures should be furnished with respect to recorded and unrecorded product or environmental remediation liabilities?

Interpretive Response: ~~Paragraphs 9 and 10 of Statement 5 [paragraphs 450-20-50-1 through 50-6]~~ FASB ASC Section 450-20-50, Contingencies—Loss Contingencies—Disclosure, identify identifies disclosures regarding loss contingencies that generally are furnished in notes to financial statements. ~~SOP 96-1 [Section 410-30-50]~~ FASB ASC Section 410-30-50, Asset Retirement and Environmental Obligations—Environmental Obligations—Disclosure, identifies identifies disclosures that are required and recommended regarding both recorded and unrecorded environmental remediation liabilities. The staff believes that product and environmental remediation liabilities typically are of such significance that detailed disclosures regarding the judgments and assumptions underlying the recognition and measurement of the liabilities are necessary to prevent the financial statements from being misleading and to inform readers fully regarding the range of reasonably possible outcomes that could have a material effect on the registrant's financial condition, results of operations, or liquidity. In addition to the disclosures required by ~~Statement 5 [Section 450-20-50]~~ FASB ASC Section 450-20-50 and ~~SOP 96-1 [Section 410-30-~~

~~50]~~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. ~~FN58~~FN49

~~FN58~~FN49 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.

The time frame over which the accrued or presently unrecognized amounts may be paid out.

Material components of the accruals and significant assumptions underlying estimates.

Registrants are cautioned that a statement that the contingency is not expected to be material does not satisfy the requirements of ~~Statement 5~~ Section 450-20-50 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 4: What disclosures should be furnished with respect to site restoration costs or other environmental remediation costs? ~~FN64~~FN52

~~FN64~~FN52 Registrants are reminded that ~~Statement 143 [Subtopic 410-20]~~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.

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. ~~FN62~~FN53 The registrant's accounting policy with respect to such costs should be disclosed in accordance with ~~Opinion 22 [Section 235-10-50]~~FASB ASC Topic 235, Notes to Financial Statements.

~~FN62~~FN53 If the company has a guarantee as defined by ~~Interpretation 45 [Section 460-10-15]~~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.

16. Amend paragraph 470-10-S99-3, with no link to a transition paragraph, as follows:

**Debt—Overall**

**SEC Materials**

**> SEC Staff Guidance**

**> > Staff Accounting Bulletins**

**> > > SAB Topic 6.H.2, Classification of Short-term ~~Obligations-~~  
~~Obligations—~~Debt Related to Long-Term Projects**

**470-10-S99-3** The following is the text of SAB Topic 6.H.2, Classification of Short-term ~~Obligations—~~~~Obligations-~~Debt Related to Long-Term Projects.

Facts: Companies engaging in significant long-term construction programs frequently arrange for revolving cover loans which extend until the completion of long-term construction projects. Such revolving cover loans are typically arranged with substantial financial institutions and typically have the following characteristics:

1. A firm long-term mortgage commitment is obtained for each project.
2. Interest rates and terms are in line with the company's normal borrowing arrangements.
3. Amounts are equal to the expected full mortgage amount of all projects.
4. The company may draw down funds at its option up to the maximum amount of the agreement.
5. The company uses short-term interim construction financing (commercial paper, bank loans, etc.) against the revolving cover loan. Such indebtedness is rolled over or drawn down on the revolving cover loan at the company's option. The company typically has regular bank lines of credit, but these generally are not legally enforceable.

Question: Under FASB ASC Subtopic 470-10, Debt—Overall, ~~Statement 6~~, will the classification of loans such as described above as long-term be acceptable?

Interpretive Response: Where such conditions exist providing for a firm commitment throughout the construction program as well as a firm commitment for permanent mortgage financing, and where there are no contingencies other than the completion of construction, the guideline criteria are met and the borrowing under such a program should be classified as long-term with appropriate disclosure.

17. Amend paragraph 480-10-S99-2, with no link to a transition paragraph, as follows:

## Distinguishing Liabilities from Equity—Overall

### SEC Materials

#### > SEC Staff Guidance

#### >> Staff Accounting Bulletins

#### >>> SAB Topic 3.C, Redeemable Preferred Stock

**480-10-S99-2** The following is the text of SAB Topic 3.C, Redeemable Preferred Stock.

Facts: Rule 5-02.278 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. ~~remove paragraph return~~ 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).~~SEC Staff Announcement: Classification and Measurement of Redeemable Securities.~~

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.

18. Amend paragraph 505-10-S99-7, with no link to a transition paragraph, as follows:

## **Equity—Overall**

### **SEC Materials**

#### **> SEC Staff Guidance**

#### **> > Staff Accounting Bulletins**

#### **> > > SAB Topic 5.Q, Increasing Rate Preferred Stock**

**505-10-S99-7** The following is the text of SAB Topic 5.Q, Increasing Rate Preferred Stock.

Facts: A registrant issues Class A and Class B nonredeemable preferred stock FN19 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.

FN19 "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.

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. FN20 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.

FN20 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.

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, FN21 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).

FN21 See Question 3 regarding variable increasing rate preferred stocks.

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

Carrying amount of preferred stock

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

During 20X4 and thereafter, the stated dividend of \$8 measured against the carrying amount of \$100 FN22 would reflect dividend cost of 8%, the market rate at time of issuance.

FN22 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.

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, APB Opinion 21 [Topic 835] 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 FN23 or nonredeemable) is irrelevant from the standpoint of common stock interests.

FN23 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, APB Opinion 21 (Topic 835), produces a constant effective periodic rate of cost that is comprised of amortization of discount as well as the stated cost in each period.

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. FN24 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).

FN24 The staff first publicly expressed its view as to the appropriate accounting at the December 3-4, 1986 meeting of the EITF.

19. Amend paragraph 505-60-S99-1, with no link to a transition paragraph, as follows:

## **Equity—Spinoffs and Reverse Spinoffs**

### **SEC Materials**

#### **> SEC Staff Guidance**

#### **> > Staff Accounting Bulletins**

#### **> > > SAB Topic 5.Z.7, Accounting for the Spin-off of a Subsidiary**

**505-60-S99-1** The following is the text of SAB Topic 5.Z.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? ~~paragraph 34 of APB Opinion 20 [paragraph 250-10-45-24]?~~

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, Statement 144 ~~[Topic 205]~~. 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). ~~Statement 131 [Topic 280]~~.

20. Amend paragraph 605-10-S99-1, with no link to a transition paragraph, as follows:

## **Revenue Recognition—Overall**

### **SEC Materials**

#### **> SEC Staff Guidance**

#### **> > Staff Accounting Bulletins**

#### **> > > SAB Topic 13, Revenue Recognition**

**605-10-S99-1** The following is the text of SAB Topic 13, Revenue Recognition.

SAB Topic 13.A, Selected Revenue Issues

SAB Topic 13.A.1, Revenue Recognition—General

The accounting literature on revenue recognition includes both broad conceptual discussions as well as certain industry-specific guidance. FN1 If a transaction is within the scope of specific authoritative literature that provides revenue recognition guidance, that literature should be applied. However, in the absence of authoritative literature addressing a specific arrangement or a specific industry, the staff will consider the existing authoritative accounting standards as well as the broad revenue recognition criteria specified in the FASB's conceptual framework that contain basic guidelines for revenue recognition.

FN1 The February 1999 AICPA publication "Audit Issues in Revenue Recognition" provides an overview of the authoritative accounting literature and auditing procedures for revenue recognition and identifies indicators of improper revenue recognition.

Based on these guidelines, revenue should not be recognized until it is realized or realizable and earned. FN2 Concepts Statement 5, Recognition

and Measurement in Financial Statements of Business Enterprises, paragraph 83(b) states that "an entity's revenue-earning activities involve delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations, and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues" [footnote reference omitted]. Paragraph 84(a) continues "the two conditions (being realized or realizable and being earned) are usually met by the time product or merchandise is delivered or services are rendered to customers, and revenues from manufacturing and selling activities and gains and losses from sales of other assets are commonly recognized at time of sale (usually meaning delivery)" [footnote reference omitted]. In addition, paragraph 84(d) states that "If services are rendered or rights to use assets extend continuously over time (for example, interest or rent), reliable measures based on contractual prices established in advance are commonly available, and revenues may be recognized as earned as time passes."

FN2 Concepts Statement 5, paragraphs 83-84; ARB 43, Chapter 1A, paragraph 1 [~~paragraph 605-10-25-1~~]FASB ASC paragraph 605-10-25-1 (Revenue Recognition Topic); FASB ASC paragraph 605-10-25-3; and Opinion 10, paragraph 12 [~~paragraph 605-10-25-3~~]FASB ASC paragraph 605-10-25-5. The citations provided herein are not intended to present the complete population of citations where a particular criterion is relevant. Rather, the citations are intended to provide the reader with additional reference material.

The staff believes that revenue generally is realized or realizable and earned when all of the following criteria are met:

Persuasive evidence of an arrangement exists, FN3

FN3 Concepts Statement 2, paragraph 63 states "Representational faithfulness is correspondence or agreement between a measure or description and the phenomenon it purports to represent." The staff believes that evidence of an exchange arrangement must exist to determine if the accounting treatment represents faithfully the transaction. See also ~~SOP 97-2, paragraph 8 [~~paragraph 985-605-25-3~~]~~FASB ASC paragraph 985-605-25-3 (Software Topic). The use of the term "arrangement" in this SAB Topic is meant to identify the final understanding between the parties as to the specific nature and terms of the agreed-upon transaction.

Delivery has occurred or services have been rendered, FN4.

FN4 Concepts Statement 5, paragraph 84(a), (b), and (d). Revenue should not be recognized until the seller has substantially accomplished what it must do pursuant to the terms of the arrangement, which usually occurs upon delivery or performance of the services.

The seller's price to the buyer is fixed or determinable, FN5 and

FN5 Concepts Statement 5, paragraph 83(a); ~~Statement 48, paragraph 6(a) [paragraph 605-15-25-1(a)]~~FASB ASC paragraph 605-15-25-1(a); ~~SOP 97-2, paragraph 8 [paragraph 985-605-25-3]~~FASB ASC paragraph 985-605-25-3. ~~SOP 97-2 [Subtopic 985-605]~~The FASB ASC Master Glossary defines a "fixed fee" as a "fee required to be paid at a set amount that is not subject to refund or adjustment. A fixed fee includes amounts designated as minimum royalties." ~~Paragraphs 26-33 of SOP 97-2 [paragraphs 985-605-25-30 through 25-40]~~FASB ASC paragraphs 985-605-25-30 through 985-605-25-40 discuss how to apply the fixed or determinable fee criterion in software transactions. The staff believes that the guidance in ~~paragraphs 26 and 30-33 [paragraphs 985-605-25-30 through 25-31 and 985-605-25-36 through 25-40]~~FASB ASC paragraphs 985-605-25-30 through 985-605-25-31 and 985-605-25-36 through 985-605-25-40 is appropriate for other sales transactions where authoritative guidance does not otherwise exist. The staff notes that ~~paragraphs 27 through 29 [paragraphs 985-605-25-33 through 25-35]~~FASB ASC paragraphs 985-605-25-33 through 985-605-25-35 specifically consider software transactions, however, the staff believes that guidance should be considered in other sales transactions in which the risk of technological obsolescence is high.

Collectibility is reasonably assured. FN6

FN6 ~~ARB 43, Chapter 1A, paragraph 1 [paragraph 605-10-25-3] and Opinion 10, paragraph 12~~FASB ASC paragraphs 605-10-25-3 through 605-10-25-5. See also Concepts Statement 5, paragraph 84(g) and ~~SOP 97-2, paragraph 8 [paragraph 985-605-25-3]~~FASB ASC paragraph 985-605-25-3.

Some revenue arrangements contain multiple revenue-generating activities. The staff believes that the determination of the units of accounting within an arrangement should be made prior to the application of the guidance in this SAB Topic by reference to the applicable accounting literature. FN7

~~FN7 See EITF Issue 00-21 paragraph 4 [paragraphs 605-25-15-2 through 15-3] FASB ASC paragraphs 605-25-15-2 through 605-25-15-3 for additional discussion.~~

## SAB Topic 13.A.2, Persuasive Evidence of an Arrangement

### Question 1.

Facts: Company A has product available to ship to customers prior to the end of its current fiscal quarter. Customer Beta places an order for the product, and Company A delivers the product prior to the end of its current fiscal quarter. Company A's normal and customary business practice for this class of customer is to enter into a written sales agreement that requires the signatures of the authorized representatives of the Company and its customer to be binding. Company A prepares a written sales agreement, and its authorized representative signs the agreement before the end of the quarter. However, Customer Beta does not sign the agreement because Customer Beta is awaiting the requisite approval by its legal department. Customer Beta's purchasing department has orally agreed to the sale and stated that it is highly likely that the contract will be approved the first week of Company A's next fiscal quarter.

Question: May Company A recognize the revenue in the current fiscal quarter for the sale of the product to Customer Beta when (1) the product is delivered by the end of its current fiscal quarter and (2) the final written sales agreement is executed by Customer Beta's authorized representative within a few days after the end of the current fiscal quarter?

Interpretive Response: No. Generally the staff believes that, in view of Company A's business practice of requiring a written sales agreement for this class of customer, persuasive evidence of an arrangement would require a final agreement that has been executed by the properly authorized personnel of the customer. In the staff's view, Customer Beta's execution of the sales agreement after the end of the quarter causes the transaction to be considered a transaction of the subsequent period. FN8 Further, if an arrangement is subject to subsequent approval (e. g., by the management committee or board of directors) or execution of another agreement, revenue recognition would be inappropriate until that subsequent approval or agreement is complete.

FN8 AU Section 560.05.

Customary business practices and processes for documenting sales transactions vary among companies and industries. Business practices and

processes may also vary within individual companies (e. g., based on the class of customer, nature of product or service, or other distinguishable factors). If a company does not have a standard or customary business practice of relying on written contracts to document a sales arrangement, it usually would be expected to have other forms of written or electronic evidence to document the transaction. For example, a company may not use written contracts but instead may rely on binding purchase orders from third parties or on-line authorizations that include the terms of the sale and that are binding on the customer. In that situation, that documentation could represent persuasive evidence of an arrangement.

The staff is aware that sometimes a customer and seller enter into "side" agreements to a master contract that effectively amend the master contract. Registrants should ensure that appropriate policies, procedures, and internal controls exist and are properly documented so as to provide reasonable assurances that sales transactions, including those affected by side agreements, are properly accounted for in accordance with GAAP and to ensure compliance with Section 13 of the Securities Exchange Act of 1934 (i. e., the Foreign Corrupt Practices Act). Side agreements could include cancellation, termination, or other provisions that affect revenue recognition. The existence of a subsequently executed side agreement may be an indicator that the original agreement was not final and revenue recognition was not appropriate.

#### Question 2.

Facts: Company Z enters into an arrangement with Customer A to deliver Company Z's products to Customer A on a consignment basis. Pursuant to the terms of the arrangement, Customer A is a consignee, and title to the products does not pass from Company Z to Customer A until Customer A consumes the products in its operations. Company Z delivers product to Customer A under the terms of their arrangement.

Question: May Company Z recognize revenue upon delivery of its product to Customer A?

Interpretive Response: No. Products delivered to a consignee pursuant to a consignment arrangement are not sales and do not qualify for revenue recognition until a sale occurs. The staff believes that revenue recognition is not appropriate because the seller retains the risks and rewards of ownership of the product and title usually does not pass to the consignee.

Other situations may exist where title to delivered products passes to a buyer, but the substance of the transaction is that of a consignment or a financing. Such arrangements require a careful analysis of the facts and

circumstances of the transaction, as well as an understanding of the rights and obligations of the parties, and the seller's customary business practices in such arrangements. The staff believes that the presence of one or more of the following characteristics in a transaction precludes revenue recognition even if title to the product has passed to the buyer:

1. The buyer has the right to return the product and:

(a) the buyer does not pay the seller at the time of sale, and the buyer is not obligated to pay the seller at a specified date or dates. FN9

~~FN9 Statement 48, paragraphs 6(b) and 22 [paragraph 605-15-25-1(b)] FASB ASC subparagraph 605-15-25-1(b).~~

(b) the buyer does not pay the seller at the time of sale but rather is obligated to pay at a specified date or dates, and the buyer's obligation to pay is contractually or implicitly excused until the buyer resells the product or subsequently consumes or uses the product, FN10

~~FN10 Statement 48, paragraphs 6(b) and 22 [paragraph 605-15-25-1(b)] FASB ASC subparagraph 605-15-25-1(b).~~  
The arrangement may not specify that payment is contingent upon subsequent resale or consumption. However, if the seller has an established business practice permitting customers to defer payment beyond the specified due date(s) until the products are resold or consumed, then the staff believes that the seller's right to receive cash representing the sales price is contingent.

(c) the buyer's obligation to the seller would be changed (e. g., the seller would forgive the obligation or grant a refund) in the event of theft or physical destruction or damage of the product, FN11.

~~FN11 Statement 48, paragraph 6(c) [paragraph 605-15-25-1(c)] FASB ASC subparagraph 605-15-25-1(c).~~

(d) the buyer acquiring the product for resale does not have economic substance apart from that provided by the seller, FN12 or

~~FN12 Statement 48, paragraph 6(d) [paragraph 605-15-25-1(d)]~~FASB ASC subparagraph 605-15-25-1(d).

(e) the seller has significant obligations for future performance to directly bring about resale of the product by the buyer. FN13

~~FN13 Statement 48, paragraph 6(e) [paragraph 605-15-25-1(e)]~~FASB ASC subparagraph 605-15-25-1(e).

2. The seller is required to repurchase the product (or a substantially identical product or processed goods of which the product is a component) at specified prices that are not subject to change except for fluctuations due to finance and holding costs, FN14 and the amounts to be paid by the seller will be adjusted, as necessary, to cover substantially all fluctuations in costs incurred by the buyer in purchasing and holding the product (including interest). FN15 The staff believes that indicators of the latter condition include:

~~FN14 Statement 49, paragraph 5(a)~~FASB ASC subparagraph 470-40-15-2(a) (Debt Topic). Paragraph 5(a) [paragraph 470-40-15-2(a)]This paragraph provides examples of circumstances that meet this requirement. As discussed further therein, this condition is present if (a) a resale price guarantee exists, (b) the seller has an option to purchase the product, the economic effect of which compels the seller to purchase the product, or (c) the buyer has an option whereby it can require the seller to purchase the product.

~~FN15 Statement 49, paragraph 5(b) [paragraph 470-40-15-2(b)]~~FASB ASC subparagraph 470-40-15-2(b).

(a) the seller provides interest-free or significantly below market financing to the buyer beyond the seller's customary sales terms and until the products are resold,

(b) the seller pays interest costs on behalf of the buyer under a third-party financing arrangement, or

(c) the seller has a practice of refunding (or intends to refund) a portion of the original sales price representative of interest expense for the period from when the buyer paid the seller until the buyer resells the product.

3. The transaction possesses the characteristics set forth in ~~ITF Issue 95-1 [paragraphs 840-10-55-12 through 55-25]~~FASB ASC paragraphs 840-10-55-12 through 840-10-55-21 (Leases Topic) and does not qualify for sales-type lease accounting.

4. The product is delivered for demonstration purposes. FN16

~~FN16 See SOP 97-2, paragraph 25 [paragraphs 985-605-25-28 through 25-29]~~FASB ASC paragraphs 985-605-25-28 through 985-605-25-29.

This list is not meant to be a checklist of all characteristics of a consignment or a financing arrangement, and other characteristics may exist. Accordingly, the staff believes that judgment is necessary in assessing whether the substance of a transaction is a consignment, a financing, or other arrangement for which revenue recognition is not appropriate. If title to the goods has passed but the substance of the arrangement is not a sale, the consigned inventory should be reported separately from other inventory in the consignor's financial statements as "inventory consigned to others" or another appropriate caption.

Question 3.

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

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

Interpretive Response: Presuming all other revenue recognition criteria have been met, the staff would not object to revenue recognition at delivery if the only rights that a seller retains with the title are those enabling recovery of the goods in the event of customer default on payment. This limited form of ownership may exist in some foreign jurisdictions where, despite technically holding title, the seller is not entitled to direct the disposition of the goods, cannot rescind the transaction, cannot prohibit its customer from moving, selling, or otherwise using the goods in the ordinary course of business, and has no other rights that rest with a titleholder of property that is subject to a lien under the U.S. UCC. On the other hand, if retaining title results in the seller retaining rights normally held by an owner

of goods, the situation is not sufficiently different from a delivery of goods on consignment. In this particular case, revenue should not be recognized until payment is received. Registrants and their auditors may wish to consult legal counsel knowledgeable of the local law and customs outside the U.S. to determine the seller's rights.

### SAB Topic 13.A.3, Delivery and Performance

#### a. Bill and hold arrangements.

Facts: Company A receives purchase orders for products it manufactures. At the end of its fiscal quarters, customers may not yet be ready to take delivery of the products for various reasons. These reasons may include, but are not limited to, a lack of available space for inventory, having more than sufficient inventory in their distribution channel, or delays in customers' production schedules.

Question: May Company A recognize revenue for the sale of its products once it has completed manufacturing if it segregates the inventory of the products in its own warehouse from its own products?

May Company A recognize revenue for the sale if it ships the products to a third-party warehouse but (1) Company A retains title to the product and (2) payment by the customer is dependent upon ultimate delivery to a customer-specified site?

Interpretative Response: Generally, no. The staff believes that delivery generally is not considered to have occurred unless the customer has taken title and assumed the risks and rewards of ownership of the products specified in the customer's purchase order or sales agreement. Typically this occurs when a product is delivered to the customer's delivery site (if the terms of the sale are "FOB destination") or when a product is shipped to the customer (if the terms are "FOB shipping point").

The Commission has set forth criteria to be met in order to recognize revenue when delivery has not occurred. FN17 These include:

FN17 See *In the Matter of Stewart Parness*, AAER 108 (August 5, 1986); *SEC v. Bollinger Industries, Inc., et al*, LR 15093 (September 30, 1996); *In the Matter of Laser Photonics, Inc.*, AAER 971 (September 30, 1997); *In the Matter of Cypress Bioscience Inc.*, AAER 817 (September 19, 1996). ~~See also~~ ~~see~~ Concepts Statement 5, paragraph 84(a)-84(a) and SOP 97-2, paragraph 22 ~~[paragraph 985-605-25-25]~~ FASB ASC paragraph 985-605-25-25.

1. The risks of ownership must have passed to the buyer;
2. The customer must have made a fixed commitment to purchase the goods, preferably in written documentation;
3. The buyer, not the seller, must request that the transaction be on a bill and hold basis. FN18 The buyer must have a substantial business purpose for ordering the goods on a bill and hold basis;

FN18 Such requests typically should be set forth in writing by the buyer.

4. There must be a fixed schedule for delivery of the goods. The date for delivery must be reasonable and must be consistent with the buyer's business purpose (e. g., storage periods are customary in the industry);
5. The seller must not have retained any specific performance obligations such that the earning process is not complete;
6. The ordered goods must have been segregated from the seller's inventory and not be subject to being used to fill other orders; and
7. The equipment [product] must be complete and ready for shipment.

The above listed conditions are the important conceptual criteria that should be used in evaluating any purported bill and hold sale. This listing is not intended as a checklist. In some circumstances, a transaction may meet all factors listed above but not meet the requirements for revenue recognition. The Commission also has noted that in applying the above criteria to a purported bill and hold sale, the individuals responsible for the preparation and filing of financial statements also should consider the following factors: FN19

FN19 See Note 17, *supra*.

1. The date by which the seller expects payment, and whether the seller has modified its normal billing and credit terms for this buyer; FN20

FN20 Such individuals should consider whether ~~Opinion 24~~ FASB ASC Subtopic 835-30, Interest—Imputation of Interest, pertaining to the need for discounting the related receivable, is applicable. ~~Opinion 24, paragraph 3(a)~~

~~[paragraph 835-30-15-3(a)]~~ FASB ASC subparagraph 835-30-15-3(a), indicates that the requirements of that ~~Opinion~~ Subtopic to record receivables at a discounted value are not intended to apply to "receivables and payables arising from transactions with customers or suppliers in the **normal course of business** which are due in customary trade terms **not exceeding approximately one year**" (emphasis added).

2. The seller's past experiences with and pattern of bill and hold transactions;
3. Whether the buyer has the expected risk of loss in the event of a decline in the market value of goods;
4. Whether the seller's custodial risks are insurable and insured;
5. Whether extended procedures are necessary in order to assure that there are no exceptions to the buyer's commitment to accept and pay for the goods sold (i. e., that the business reasons for the bill and hold have not introduced a contingency to the buyer's commitment).

Delivery generally is not considered to have occurred unless the product has been delivered to the customer's place of business or another site specified by the customer. If the customer specifies an intermediate site but a substantial portion of the sales price is not payable until delivery is made to a final site, then revenue should not be recognized until final delivery has occurred. FN21

FN21 ~~SOP 97-2, paragraph 22 [paragraph 985-605-25-25]~~ FASB ASC paragraph 985-605-25-25.

b. Customer acceptance.

After delivery of a product or performance of a service, if uncertainty exists about customer acceptance, revenue should not be recognized until acceptance occurs. FN22 Customer acceptance provisions may be included in a contract, among other reasons, to enforce a customer's rights to (1) test the delivered product, (2) require the seller to perform additional services subsequent to delivery of an initial product or performance of an initial service (e. g., a seller is required to install or activate delivered equipment), or (3) identify other work necessary to be done before accepting the product. The staff presumes that such contractual customer acceptance provisions are substantive, bargained-for terms of an arrangement. Accordingly, when such contractual customer acceptance

provisions exist, the staff generally believes that the seller should not recognize revenue until customer acceptance occurs or the acceptance provisions lapse.

~~FN22 SOP 97-2, paragraph 20 [paragraph 985-605-25-21]~~ FASB ASC paragraph 985-605-25-21. Also, Concepts Statement 5, paragraph 83(b) states "revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues." If an arrangement expressly requires customer acceptance, the staff generally believes that customer acceptance should occur before the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues, especially when the seller is obligated to perform additional steps.

#### Question 1.

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

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

(a) Acceptance provisions in arrangements that purport to be for trial or evaluation purposes. FN23 In these arrangements, the seller delivers a product to a customer, and the customer agrees to receive the product, solely to give the customer the ability to evaluate the delivered product prior to acceptance. The customer does not agree to purchase the delivered product until it accepts the product. In some cases, the acceptance provisions lapse by the passage of time without the customer rejecting the delivered product, and in other cases affirmative acceptance from the customer is necessary to trigger a sales transaction. Frequently, the title to the product does not transfer and payment terms are not established prior to customer acceptance.

These arrangements are, in substance, consignment arrangements until the customer accepts the product as set forth in the contract with the seller. Accordingly, in arrangements where products are delivered for trial or evaluation purposes, revenue should not be recognized until the earlier of when acceptance occurs or the acceptance provisions lapse.

FN23 See, for example, ~~SOP 97-2, paragraph 25 [paragraphs 985-605-25-28 through 25-29]~~FASB ASC paragraphs 985-605-25-28 through 985-605-25-29.

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

(b) Acceptance provisions that grant a right of return or exchange on the basis of subjective matters. An example of such a provision is one that allows the customer to return a product if the customer is dissatisfied with the product. FN24 The staff believes these provisions are not different from general rights of return and should be accounted for in accordance with ~~Statement 48 [Subtopic 605-15]~~FASB ASC Subtopic 605-15, Revenue Recognition—Products. Statement 48 [Subtopic 605-15]~~This Subtopic~~This Subtopic requires that the amount of future returns must be reasonably estimable in order for revenue to be recognized prior to the expiration of return rights. FN25 That estimate may not be made in the absence of a large volume of homogeneous transactions or if customer acceptance is likely to depend on conditions for which sufficient historical experience is absent. FN26 Satisfaction of these requirements may vary from product-to-product, location-to-location, customer-to-customer, and vendor-to-vendor.

FN24 ~~Statement 48, paragraph 13 [paragraph 605-15-05-3]~~FASB ASC paragraph 605-15-05-3.

FN25 ~~Statement 48, paragraph 6(f) [paragraph 605-15-25-1(f)]~~FASB ASC subparagraph 605-15-25-1(f).

FN26 ~~Statement 48, paragraphs 8(c) and 8(d) [paragraph 605-15-25-3(c) and (d)]~~FASB ASC subparagraphs 605-15-25-3(c) and 605-15-25-3(d).

(c) Acceptance provisions based on seller-specified objective criteria. An example of such a provision is one that gives the customer a right of return or replacement if the delivered product is defective or fails to meet the vendor's published specifications for the product. FN27 Such rights are generally identical to those granted to all others within the same class of customer and for which satisfaction can be generally assured without consideration of conditions specific to the customer. Provided the seller has previously demonstrated that the product meets the specified criteria, the staff believes that these provisions are not different from general or specific warranties and should be accounted for as warranties in accordance with Statement 5 [Section 460-10-25] FASB ASC Subtopic 450-20, Contingencies—Loss Contingencies. In this case, the cost of potentially defective goods must be reliably estimable based on a demonstrated history of substantially similar transactions. FN28 However, if the seller has not previously demonstrated that the delivered product meets the seller's specifications, the staff believes that revenue should be deferred until the specifications have been objectively achieved.

FN27 Statement 5, paragraph 24 and Statement 48, paragraph 4(c) [paragraphs 460-10-25-5 and 605-15-15-3(c)] FASB ASC paragraph 460-10-25-5 (Guarantees Topic) and FASB ASC paragraph 605-15-15-3(c).

FN28 Statement 5, paragraph 25 [paragraph 460-10-25-6] FASB ASC paragraph 460-10-25-6.

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

customer acceptance is a matter of contract law, and depending on the facts and circumstances, an opinion of counsel may be necessary to reach a conclusion.

## Question 2.

Facts: Consider an arrangement that calls for the transfer of title to equipment upon delivery to a customer's site. However, customer-specific acceptance provisions permit the customer to return the equipment unless the equipment satisfies certain performance tests. The arrangement calls for the vendor to perform the installation. Assume the equipment and the installation are separate units of accounting under ~~ITF Issue 00-21 [Subtopic 605-25]~~ FASB ASC Subtopic 605-25, Revenue Recognition—Multiple-Element Arrangements. FN29

FN29 This fact is provided as an assumption to facilitate an analysis of revenue recognition in this fact pattern. No interpretation of ~~Issue 00-21 [Subtopic 605-25]~~ FASB ASC Subtopic 605-25 is intended.

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

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

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

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

specifications also may provide sufficient evidence that the currently shipped equipment satisfies the customer-specific acceptance provisions.

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

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

### Question 3.

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

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

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

Interpretive Response: While the staff presumes that customer acceptance provisions are substantive provisions that generally result in revenue deferral, that presumption can be overcome as discussed above. Although the contract includes a customer acceptance clause, acceptance is based on meeting Company E's published specifications for a standard model. Company E demonstrates that the equipment shipped meets the specifications before shipment, and the equipment is expected to operate the same in the customer's environment as it does in Company E's. In this situation, Company E should evaluate the customer acceptance provision as a warranty under ~~Statement 5 [Section 460-10-25]~~ FASB ASC Subtopic 450-20. If Company E can reasonably and reliably estimate the amount of warranty obligations, the staff believes that it should recognize revenue upon delivery of the equipment, with an appropriate liability for probable warranty obligations.

Question 4.

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

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

Interpretive Response: Although the contract includes a customer acceptance clause that is based, in part, on a customer specific criterion, Company E demonstrates that the equipment shipped meets that objective criterion, as well as the published specifications, before shipment. The staff believes that the customer acceptance provisions related to the standard performance specifications should be evaluated as a warranty under ~~Statement 5 (Section 460-10-25)~~ FASB ASC Subtopic 450-20. If Company E can reasonably and reliably estimate the amount of warranty obligations, it should recognize revenue upon delivery of the equipment, with an appropriate liability for probable warranty obligations.

#### Question 5.

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

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

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

has met the customer-specific criteria may also exist (e. g., confirmation from the customer that the specifications were met).

c. Inconsequential or perfunctory performance obligations.

Question 1.

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

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

A seller should substantially complete or fulfill the terms specified in the arrangement related to the unit of accounting at issue in order for delivery or performance to have occurred. FN30 When applying the substantially complete notion, the staff believes that only inconsequential or perfunctory actions may remain incomplete such that the failure to complete the actions would not result in the customer receiving a refund or rejecting the delivered products or services performed to date. In addition, the seller should have a demonstrated history of completing the remaining tasks in a timely manner and reliably estimating the remaining costs. If revenue is recognized upon substantial completion of the terms specified in the arrangement related to the unit of accounting at issue, all related costs of performance or delivery should be accrued.

FN30 Concepts Statement 5, paragraph 83(b) states "revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled the benefits represented by the revenues."

Question 2.

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

Interpretive Response: A remaining performance obligation is not inconsequential or perfunctory if it is essential to the functionality of the delivered products or services. In addition, remaining activities are not inconsequential or perfunctory if failure to complete the activities would result in the customer receiving a full or partial refund or rejecting (or a right to a refund or to reject) the products delivered or services performed to

date. The terms of the sales contract regarding both the right to a full or partial refund and the right of return or rejection should be considered when evaluating whether a portion of the purchase price would be refundable. If the company has a historical pattern of granting such rights, that historical pattern should also be considered even if the current contract expressly precludes such rights. Further, other factors should be considered in assessing whether remaining obligations are inconsequential or perfunctory. For example, the staff also considers the following factors, which are not all-inclusive, to be indicators that a remaining performance obligation is substantive rather than inconsequential or perfunctory:

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

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

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

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

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

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

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

### Question 3.

Facts: Consider a unit of accounting that includes both equipment and installation because the two deliverables do not meet the separation criteria under ~~ETF Issue 00-24~~ ~~(Subtopic 605-25)~~ FASB ASC Subtopic 605-25. This may be because the equipment does not have value to the customer on a standalone basis, there is no objective and reliable evidence of fair value for the installation or there is a general right of return when the installation is not considered probable and in control of the vendor.

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

Interpretive Response: Yes, if installation is essential to the functionality of the equipment. FN31 Examples of indicators that installation is essential to the functionality of equipment include:

FN31 ~~See SOP 97-2, paragraph 13 [paragraph 985-605-25-12]~~FASB ASC paragraph 985-605-25-12.

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

The installation services are unavailable from other vendors. FN32

FN32 ~~See SOP 97-2, paragraphs 68-71 [paragraphs 985-605-25-81 through 25-85]~~FASB ASC paragraphs 985-605-25-81 through 985-605-25-85 for analogous guidance.

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

The equipment is a standard product;

Installation does not significantly alter the equipment's capabilities;

Other companies are available to perform the installation. FN33

FN33 Ibid.

If it is determined that the undelivered service is not essential to the functionality of the delivered product but a portion of the contract fee is not payable until the undelivered service is delivered, the staff would not consider that obligation to be inconsequential or perfunctory. Generally, the portion of the contract price that is withheld or refundable should be deferred until the outstanding service is delivered because that portion would not be realized or realizable. FN34

FN34 ~~Concepts Statement 5, paragraph 83(a) and Statement 48, paragraph 6(b) [paragraph 605-15-25-1(b)]~~FASB ASC subparagraph 605-15-25-1(b).

d. License fee revenue.

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

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

Interpretive Response: No. In licensing and similar arrangements (e. g., licenses of motion pictures, software, technology, and other intangibles), the staff believes that delivery does not occur for revenue recognition purposes until the license term begins. FN35 Accordingly, if a licensed product or technology is physically delivered to the customer, but the license term has not yet begun, revenue should not be recognized prior to inception of the license term. Upon inception of the license term, revenue should be recognized in a manner consistent with the nature of the transaction and the earnings process.

FN35 SOP 00-2, paragraph 7 [paragraph 926-605-25-1] FASB ASC paragraph 926-605-25-1 (Entertainment—Films Topic).

e. Layaway sales arrangements.

Facts: Company R is a retailer that offers "layaway" sales to its customers. Company R retains the merchandise, sets it aside in its inventory, and collects a cash deposit from the customer. Although Company R may set a time period within which the customer must finalize the purchase, Company R does not require the customer to enter into an installment note or other fixed payment commitment or agreement when the initial deposit is received. The merchandise generally is not released to the customer until the customer pays the full purchase price. In the event that the customer fails to pay the remaining purchase price, the customer forfeits its cash deposit. In the event the merchandise is lost, damaged, or destroyed, Company R either must refund the cash deposit to the customer or provide replacement merchandise.

Question: In the staff's view, when may Company R recognize revenue for merchandise sold under its layaway program?

Interpretive Response: Provided that the other criteria for revenue recognition are met, the staff believes that Company R should recognize revenue from sales made under its layaway program upon delivery of the merchandise to the customer. Until then, the amount of cash received should be recognized as a liability entitled such as "deposits received from

customers for layaway sales" or a similarly descriptive caption. Because Company R retains the risks of ownership of the merchandise, receives only a deposit from the customer, and does not have an enforceable right to the remainder of the purchase price, the staff would object to Company R recognizing any revenue upon receipt of the cash deposit. This is consistent with item two (2) in the Commission's criteria for bill-and-hold transactions which states "the customer must have made a fixed commitment to purchase the goods."

f. Nonrefundable up-front fees.

Question 1.

Facts: Registrants may negotiate arrangements pursuant to which they may receive nonrefundable fees upon entering into arrangements or on certain specified dates. The fees may ostensibly be received for conveyance of a license or other intangible right or for delivery of particular products or services. Various business factors may influence how the registrant and customer structure the payment terms. For example, in exchange for a greater up-front fee for an intangible right, the registrant may be willing to receive lower unit prices for related products to be delivered in the future. In some circumstances, the right, product, or service conveyed in conjunction with the nonrefundable fee has no utility to the purchaser separate and independent of the registrant's performance of the other elements of the arrangement. Therefore, in the absence of the registrant's continuing involvement under the arrangement, the customer would not have paid the fee. Examples of this type of arrangement include the following:

A registrant sells a lifetime membership in a health club. After paying a nonrefundable "initiation fee," the customer is permitted to use the health club indefinitely, so long as the customer also pays an additional usage fee each month. The monthly usage fees collected from all customers are adequate to cover the operating costs of the health club.

A registrant in the biotechnology industry agrees to provide research and development activities for a customer for a specified term. The customer needs to use certain technology owned by the registrant for use in the research and development activities. The technology is not sold or licensed separately without the research and development activities. Under the terms of the arrangement, the customer is required to pay a nonrefundable "technology access fee" in addition to periodic payments for research and development activities over the term of the contract.

A registrant requires a customer to pay a nonrefundable "activation fee" when entering into an arrangement to provide telecommunications services.

The terms of the arrangement require the customer to pay a monthly usage fee that is adequate to recover the registrant's operating costs. The costs incurred to activate the telecommunications service are nominal.

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

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

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

Question: Assuming these arrangements qualify as single units of accounting under ~~EITF Issue 00-21 [Subtopic 605-25]~~FASB ASC Subtopic 605-25 FN36, when should the revenue relating to nonrefundable, up-front fees in these types of arrangements be recognized?

FN36 The staff believes that the vendor activities associated with the up-front fee, even if considered a deliverable to be evaluated under ~~EITF Issue 00-21 [Subtopic 605-25]~~FASB ASC Subtopic 605-25, will rarely provide value to the customer on a standalone basis.

Interpretive Response: The staff believes that registrants should consider the specific facts and circumstances to determine the appropriate accounting for nonrefundable, up-front fees. Unless the up-front fee is in exchange for products delivered or services performed that represent the culmination of a separate earnings process, FN37 the deferral of revenue is appropriate.

FN37 See Concepts Statement 5, footnote 51, for a description of the "earning process."

In the situations described above, the staff does not view the activities completed by the registrants (i. e., selling the membership, signing the

contract, enrolling the customer, activating telecommunications services or providing initial set-up services) as discrete earnings events. FN38 The terms, conditions, and amounts of these fees typically are negotiated in conjunction with the pricing of all the elements of the arrangement, and the customer would ascribe a significantly lower, and perhaps no, value to elements ostensibly associated with the up-front fee in the absence of the registrant's performance of other contract elements. The fact that the registrants do not sell the initial rights, products, or services separately (i. e., without the registrants' continuing involvement) supports the staff's view. The staff believes that the customers are purchasing the on-going rights, products, or services being provided through the registrants' continuing involvement. Further, the staff believes that the earnings process is completed by performing under the terms of the arrangements, not simply by originating a revenue-generating arrangement.

FN38 In a similar situation, lenders may collect nonrefundable loan origination fees in connection with lending activities. The FASB concluded in Statement 91 [Subtopic 310-20] FASB ASC Subtopic 310-20, Receivables—Nonrefundable Fees and Other Costs, that loan origination is not a separate revenue-producing activity of a lender, and therefore, those nonrefundable fees collected at the outset of the loan arrangement are not recognized as revenue upon receipt but are deferred and recognized over the life of the loan (paragraphs 5 and 37 of FAS 91 [paragraph 310-20-35-2] FASB ASC paragraph 310-20-35-2).

While the incurrence of nominal up-front costs helps make it clear that there is not a separate earnings event in the telecommunications example above, incurrence of substantive costs, such as in the web hosting example above, does not necessarily indicate that there is a separate earnings event. Whether there is a separate earnings event should be evaluated on a case-by-case basis. Some have questioned whether revenue may be recognized in these transactions to the extent of the incremental direct costs incurred in the activation. Because there is no separable deliverable or earnings event, the staff would generally object to that approach, except where it is provided for in the authoritative literature (e. g., Statement 51 [Sections 922-605-25 and 922-430-25] FASB ASC Subtopic 922-605, Entertainment—Cable Television—Revenue Recognition).

Supply or service transactions may involve the charge of a nonrefundable initial fee with subsequent periodic payments for future products or services. The initial fees may, in substance, be wholly or partly an advance payment for future products or services. In the examples above, the on-going rights or services being provided or products being delivered are essential to the customers receiving the expected benefit of the up-front

payment. Therefore, the up-front fee and the continuing performance obligation related to the services to be provided or products to be delivered are assessed as an integrated package. In such circumstances, the staff believes that up-front fees, even if nonrefundable, are earned as the products and/or services are delivered and/or performed over the term of the arrangement or the expected period of performance FN39 and generally should be deferred and recognized systematically over the periods that the fees are earned. FN40

FN39 The revenue recognition period should extend beyond the initial contractual period if the relationship with the customer is expected to extend beyond the initial term and the customer continues to benefit from the payment of the up-front fee (e. g., if subsequent renewals are priced at a bargain to the initial up-front fee).

FN40 A systematic method would be on a straight-line basis, unless evidence suggests that revenue is earned or obligations are fulfilled in a different pattern, in which case that pattern should be followed.

Some propose that revenue should be recognized when the initial set-up is completed in cases where the on-going obligation involves minimal or no cost or effort and should, therefore, be considered perfunctory or inconsequential. However, the staff believes that the substance of each of these transactions indicates that the purchaser is paying for a service that is delivered over time. Therefore, revenue recognition should occur over time, reflecting the provision of service. FN41

FN41 Concepts Statement 5, paragraph 84(d).

## Question 2.

Facts: Company A provides its customers with activity tracking or similar services (e. g., tracking of property tax payment activity, sending delinquency letters on overdue accounts, etc.) for a ten-year period. Company A requires customers to prepay for all the services for the term specified in the arrangement. The on-going services to be provided are generally automated after the initial customer set-up. At the outset of the arrangement, Company A performs set-up procedures to facilitate delivery of its on-going services to the customers. Such procedures consist primarily of establishing the necessary records and files in Company A's pre-existing computer systems in order to provide the services. Once the initial customer set-up activities are complete, Company A provides its services in accordance with the arrangement. Company A is not required to refund any portion of the fee if the customer terminates the services or does not utilize all of the services to which it is entitled. However, Company A is required to

provide a refund if Company A terminates the arrangement early. Assume Company A's activities are not within the scope of ~~Statement 91 [Subtopic 310-20]~~FASB ASC Subtopic 310-20, Receivables—Nonrefundable Fees and Other Costs, and that this arrangement qualifies as a single unit of accounting under ~~ETTF Issue 00-21 [Subtopic 605-25]~~FASB ASC Subtopic 605-25. FN42

FN42 See Note 36, supra.

Question: When should Company A recognize the service revenue?

Interpretive Response: The staff believes that, provided all other revenue recognition criteria are met, service revenue should be recognized on a straight-line basis, unless evidence suggests that the revenue is earned or obligations are fulfilled in a different pattern, over the contractual term of the arrangement or the expected period during which those specified services will be performed, FN43 whichever is longer. In this case, the customer contracted for the on-going activity tracking service, not for the set-up activities. The staff notes that the customer could not, and would not, separately purchase the set-up services without the on-going services. The services specified in the arrangement are performed continuously over the contractual term of the arrangement (and any subsequent renewals). Therefore, the staff believes that Company A should recognize revenue on a straight-line basis, unless evidence suggests that the revenue is earned or obligations are fulfilled in a different pattern, over the contractual term of the arrangement or the expected period during which those specified services will be performed, whichever is longer.

FN43 See Note 39, supra.

In this situation, the staff would object to Company A recognizing revenue in proportion to the costs incurred because the set-up costs incurred bear no direct relationship to the performance of services specified in the arrangement. The staff also believes that it is inappropriate to recognize the entire amount of the prepayment as revenue at the outset of the arrangement by accruing the remaining costs because the services required by the contract have not been performed.

Question 3.

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

Question: Are the initial customer set-up costs incurred by Company A within the scope of ~~SOP 98-5 [Subtopic 720-15]~~FASB ASC Subtopic 720-15, Other Expenses—Start-Up Costs?

Interpretive Response: ~~Footnote 1 of SOP 98-5 [Section 720-15-15]~~FASB ASC paragraph 720-15-15-4 states that ~~"this SOP~~the guidance does not address the financial reporting of costs incurred related to ~~ongoing~~"ongoing customer acquisition, acquisition costs, such as policy acquisition costs" addressed in ~~Statement 60 [Subtopic 944-30]~~FASB ASC Subtopic 944-30, Financial Services—Insurance—Acquisition Costs, and loan ~~"loan origination costs"~~"loan origination costs" addressed in ~~Statement 91 [Subtopic 310-20]~~FASB ASC Subtopic 310-20. ~~The SOP~~This guidance addresses the more substantive one-time efforts to establish business with an entirely new class of customers (for example, a manufacturer who does all of its business with retailers attempts to sell merchandise directly to the ~~public~~public). As such, the set-up costs incurred in this example are not within the scope of ~~SOP 98-5 [Subtopic 720-15]~~FASB ASC Subtopic 720-15.

The staff believes that the incremental direct costs (~~Statement 91~~the FASB ASC Master Glossary provides ~~an analogous~~a definition) incurred related to the acquisition or origination of a customer contract in a transaction that results in the deferral of revenue, unless specifically provided for in the authoritative literature, may be either expensed as incurred or accounted for in accordance with ~~paragraph 4 of Technical Bulletin 90-1 [paragraph 605-20-25-4]~~FASB ASC paragraph 605-20-25-4 or ~~paragraph 5 of Statement 91 [paragraph 310-20-35-2]~~FASB ASC paragraph 310-20-25-2. The staff believes the accounting policy chosen for these costs should be disclosed and applied consistently.

Question 4.

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

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

Interpretive Response: As noted in Question 3 above, ~~Statement 91~~the FASB ASC Master Glossary includes a definition of incremental direct costs ~~in its glossary~~in its glossary. ~~Paragraph 6 of Statement 91 [Section 310-20-25]~~FASB ASC Subtopic 310-10, Receivables—Overall, provides further guidance on the types of costs eligible for capitalization as customer acquisition costs indicating that only costs that result from successful loan origination efforts are capitalized. ~~The FASB staff has published an Implementation Guide on Statement 91 [Subtopic 310-20] that provides additional guidance on the~~

~~costs that qualify for capitalization as customer acquisition costs. Further, Technical Bulletin 90-1 [paragraph 605-20-25-4]FASB ASC Subtopic 605-20, Revenue Recognition—Services, also requires capitalization of incremental direct customer acquisition costs and requires that those costs be "identified consistent with the guidance in paragraph 6 of Statement 91 [Section 310-20-25]"costs. Although the facts of a particular situation should be analyzed closely to capture those costs that are truly direct and incremental, the staff generally would not object to an accounting policy that results in the capitalization of costs in accordance with paragraph 6(a) and (b) of Statement 91 [Section 310-20-25]FASB ASC Subtopic 310-20, Receivables—Nonrefundable Fees and Other Costs, or Technical Bulletin 90-1 [paragraph 605-25-25-4]FASB ASC Subtopic 605-20. Registrants should disclose their policies for determining which costs to capitalize as contract acquisition and origination costs.~~

Question 5.

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

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

Interpretive Response: When both costs and revenue (in an amount equal to or greater than the costs) are deferred, the staff believes that the capitalized costs should be charged to expense proportionally and over the same period that deferred revenue is recognized as revenue. FN44

~~FN44 Technical Bulletin 90-1, paragraph 4 [paragraph 605-20-25-4]FASB ASC paragraph 605-20-25-4.~~

g. Deliverables within an arrangement.

Question: If a company (the seller) has a patent to its intellectual property which it licenses to customers, the seller may represent and warrant to its licensees that it has a valid patent, and will defend and maintain that patent. Does that obligation to maintain and defend patent rights, in and of itself, constitute a deliverable to be evaluated under ~~EITF Issue 00-21 [Subtopic 605-25]FASB ASC Subtopic 605-25?~~

Interpretive Response: No. Provided the seller has legal and valid patents upon entering the license arrangement, existing GAAP on licenses of intellectual property, (e. g., SOP 97-2 [Subtopic 985-605], SOP 00-2,

~~[Subtopic 926-605], and SFAS No. 50 [Subtopic 928-605]~~property (e. g., ~~FASB ASC Subtopic 985-605, Software—Revenue Recognition, FASB ASC Subtopic 926-605, Entertainment—Films—Revenue Recognition, and FASB ASC Subtopic 928-605, Entertainment—Music—Revenue Recognition~~) does not indicate that an obligation to defend valid patents represents an additional deliverable to which a portion of an arrangement fee should be allocated in an arrangement that otherwise qualifies for sales-type accounting. While this clause may obligate the licensor to incur costs in the defense and maintenance of the patent, that obligation does not involve an additional deliverable to the customer. Defending the patent is generally consistent with the seller's representation in the license that such patent is legal and valid. Therefore, the staff would not consider a clause like this to represent an additional deliverable in the arrangement. FN45

FN45 Note, however, the staff believes that this obligation qualifies as a guarantee within the scope of ~~FIN 45 [Subtopic 460-10]~~FASB ASC Topic 460, subject to a scope exception from the initial recognition and measurement provisions.

#### SAB Topic 13.A.4, Fixed or Determinable Sales Price

##### a. Refundable fees for services.

A company's contracts may include customer cancellation or termination clauses. Cancellation or termination provisions may be indicative of a demonstration period or an otherwise incomplete transaction. Examples of transactions that financial management and auditors should be aware of and where such provisions may exist include "side" agreements and significant transactions with unusual terms and conditions. These contractual provisions raise questions as to whether the sales price is fixed or determinable. The sales price in arrangements that are cancelable by the customer is neither fixed nor determinable until the cancellation privileges lapse. FN46 If the cancellation privileges expire ratably over a stated contractual term, the sales price is considered to become determinable ratably over the stated term. FN47 Short-term rights of return, such as thirty-day money-back guarantees, and other customary rights to return products are not considered to be cancellation privileges, but should be accounted for in accordance with ~~Statement 48 [Subtopic 605-15]~~FASB ASC Subtopic 605-15, Revenue Recognition—Products. FN48

FN46 ~~SOP 97-2, paragraph 31 [paragraph 985-605-25-37]~~FASB ASC paragraph 985-605-25-37.

FN47 Ibid.

FN48 Ibid.

Question 1.

Facts: Company M is a discount retailer. It generates revenue from annual membership fees it charges customers to shop at its stores and from the sale of products at a discount price to those customers. The membership arrangements with retail customers require the customer to pay the entire membership fee (e. g., \$35) at the outset of the arrangement. However, the customer has the unilateral right to cancel the arrangement at any time during its term and receive a full refund of the initial fee. Based on historical data collected over time for a large number of homogeneous transactions, Company M estimates that approximately 40% of the customers will request a refund before the end of the membership contract term. Company M's data for the past five years indicates that significant variations between actual and estimated cancellations have not occurred, and Company M does not expect significant variations to occur in the foreseeable future.

Question: May Company M recognize in earnings the revenue for the membership fees and accrue the costs to provide membership services at the outset of the arrangement?

Interpretive Response: No. In the staff's view, it would be inappropriate for Company M to recognize the membership fees as earned revenue upon billing or receipt of the initial fee with a corresponding accrual for estimated costs to provide the membership services. This conclusion is based on Company M's remaining and unfulfilled contractual obligation to perform services (i. e., make available and offer products for sale at a discounted price) throughout the membership period. Therefore, the earnings process, irrespective of whether a cancellation clause exists, is not complete.

In addition, the ability of the member to receive a full refund of the membership fee up to the last day of the membership term raises an uncertainty as to whether the fee is fixed or determinable at any point before the end of the term. Generally, the staff believes that a sales price is not fixed or determinable when a customer has the unilateral right to terminate or cancel the contract and receive a cash refund. A sales price or fee that is variable until the occurrence of future events (other than product returns that are within the scope of ~~Statement 48 [Subtopic 605-15]~~ FASB ASC Subtopic 605-15) generally is not fixed or determinable until the future event occurs. The revenue from such transactions should not be recognized in earnings until the sales price or fee becomes fixed or determinable. Moreover, revenue should not be recognized in earnings by assessing the probability that significant, but unfulfilled, terms of a contract will be fulfilled at some point in the future. Accordingly, the revenue from

such transactions should not be recognized in earnings prior to the refund privileges expiring. The amounts received from customers or subscribers (i. e., the \$35 fee mentioned above) should be credited to a monetary liability account such as "customers' refundable fees." fees."

The staff believes that if a customer has the unilateral right to receive both (1) the seller's substantial performance under an arrangement (e. g., providing services or delivering product) and (2) a cash refund of prepaid fees, then the prepaid fees should be accounted for as a monetary liability. In consideration of whether the monetary liability can be derecognized, ~~Statement 140~~FASB ASC Topic 860, Transfers and Servicing, provides that liabilities may be derecognized only if (1) the debtor pays the creditor and is relieved of its obligation for the liability (paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities) or (2) the debtor is legally released from being the primary obligor under the liability. ~~FN49~~FN49 If a customer has the unilateral right to receive both (1) the seller's substantial performance under the arrangement and (2) a cash refund of prepaid fees, then the refund obligation is not relieved upon performance of the service or delivery of the products. Rather, the seller's refund obligation is relieved only upon refunding the cash or expiration of the refund privilege.

~~FN49 Statement 140, paragraph 16 [paragraph 405-20-40-1]~~FASB ASC paragraph 405-20-40-1 (Liabilities Topic).

Some have argued that there may be a limited exception to the general rule that revenue from membership or other service transaction fees should not be recognized in earnings prior to the refund privileges expiring. Despite the fact that ~~Statement 48 [Subtopic 605-15]~~FASB ASC Subtopic 605-15 expressly does not apply to the accounting for service revenue if part or all of the service fee is refundable under cancellation privileges granted to the buyer, ~~FN50~~ they believe that in certain circumstances a potential refund of a membership fee may be seen as being similar to a right of return of products under ~~Statement 48 [Subtopic 605-15]~~FASB ASC Subtopic 605-15. They argue that revenue from membership fees, net of estimated refunds, may be recognized ratably over the period the services are performed whenever pertinent conditions of ~~Statement 48 [Subtopic 605-15]~~FASB ASC Subtopic 605-15 are met, namely, there is a large population of transactions that grant customers the same unilateral termination or cancellation rights and reasonable estimates can be made of how many customers likely will exercise those rights.

~~FN50 Statement 48, paragraph 4 [paragraph 605-15-15-3]~~FASB ASC paragraph 605-15-15-3.

The staff believes that, because service arrangements are specifically excluded from the scope of ~~Statement 48 [Subtopic 605-15]~~FASB ASC Subtopic 605-15, the most direct authoritative literature to be applied to the extinguishment of obligations under such contracts is ~~Statement 140 [Subtopic 405-20]~~FASB ASC Topic 860. As noted above, because the refund privilege extends to the end of the contract term irrespective of the amount of the service performed, ~~Statement 140 [Subtopic 405-20]~~FASB ASC Topic 860 indicates that the liability would not be extinguished (and therefore no revenue would be recognized in earnings) until the cancellation or termination and related refund privileges expire. Nonetheless, the staff recognizes that over the years the accounting for membership refunds evolved based on analogy to ~~Statement 48 [Subtopic 605-15]~~FASB ASC Subtopic 605-15 and that practice did not change when ~~Statement 140 [Subtopic 405-20]~~FASB ASC Topic 860 became effective. Reasonable people held, and continue to hold, different views about the application of the accounting literature.

Pending further action in this area by the FASB, the staff will not object to the recognition of refundable membership fees, net of estimated refunds, as earned revenue over the membership term in the limited circumstances where all of the following criteria have been met: FN51

FN51 The staff will question further analogies to the guidance in ~~Statement 48 [Subtopic 605-15]~~FASB ASC Subtopic 605-15 for transactions expressly excluded from its scope.

The estimates of terminations or cancellations and refunded revenues are being made for a large pool of homogeneous items (e. g., membership or other service transactions with the same characteristics such as terms, periods, class of customers, nature of service, etc.).

Reliable estimates of the expected refunds can be made on a timely basis. FN52 Either of the following two items would be considered indicative of an inability to make reliable estimates: (1) recurring, significant differences between actual experience and estimated cancellation or termination rates (e. g., an actual cancellation rate of 40% versus an estimated rate of 25%) even if the impact of the difference on the amount of estimated refunds is not material to the consolidated financial statements FN53 or (2) recurring variances between the actual and estimated amount of refunds that are material to either revenue or net income in quarterly or annual financial statements. In addition, the staff believes that an estimate, for purposes of meeting this criterion, would not be reliable unless it is remote FN54 that material adjustments (both individually and in the aggregate) to previously recognized revenue would be required. The staff presumes that reliable

estimates cannot be made if the customer's termination or cancellation and refund privileges exceed one year.

FN52 Reliability is defined in Concepts Statement 2 as "the quality of information that assures that information is reasonably free from error and bias and faithfully represents what it purports to represent." Paragraph 63 of Concepts Statement 5 reiterates the definition of reliability, requiring that "the information is representationally faithful, verifiable, and ~~neutral.~~neutral."

FN53 For example, if an estimate of the expected cancellation rate varies from the actual cancellation rate by 100% but the dollar amount of the error is immaterial to the consolidated financial statements, some would argue that the estimate could still be viewed as reliable. The staff disagrees with that argument.

FN54 The term "remote" is used here with the same definition as used in ~~Statement 5~~the FASB ASC Master Glossary.

There is a sufficient company-specific historical basis upon which to estimate the refunds, FN55 and the company believes that such historical experience is predictive of future events. In assessing these items, the staff believes that estimates of future refunds should take into consideration, among other things, such factors as historical experience by service type and class of customer, changing trends in historical experience and the basis thereof (e. g., economic conditions), the impact or introduction of competing services or products, and changes in the customer's "accessibility" to the refund (i. e., how easy it is for customers to obtain the refund).

FN55 ~~Paragraph 8 of Statement 48 [paragraph 605-15-25-3]~~FASB ASC paragraph 605-15-25-3 notes various factors that may impair the ability to make a reasonable estimate of returns, including the lack of sufficient historical experience. The staff typically expects that the historical experience be based on the particular registrant's historical experience for a service and/or class of customer. In general, the staff typically expects a start-up company, a company introducing new services, or a company introducing services to a new class of customer to have at least two years of experience to be able to make reasonable and reliable estimates.

The amount of the membership fee specified in the agreement at the outset of the arrangement is fixed, other than the customer's right to request a refund.

If Company M does not meet all of the foregoing criteria, the staff believes that Company M should not recognize in earnings any revenue for the membership fee until the cancellation privileges and refund rights expire.

If revenue is recognized in earnings over the membership period pursuant to the above criteria, the initial amounts received from customer or subscribers (i. e., the \$35 fee mentioned above) should be allocated to two liability accounts. The amount of the fee representing estimated refunds should be credited to a monetary liability account, such as "customers' refundable fees," and the remaining amount of the fee representing unearned revenue should be credited to a nonmonetary liability account, such as "unearned revenues." For each income statement presented, registrants should disclose in the footnotes to the financial statements the amounts of (1) the unearned revenue and (2) refund obligations as of the beginning of each period, the amount of cash received from customers, the amount of revenue recognized in earnings, the amount of refunds paid, other adjustments (with an explanation thereof), and the ending balance of (1) unearned revenue and (2) refund obligations.

If revenue is recognized in earnings over the membership period pursuant to the above criteria, the staff believes that adjustments for changes in estimated refunds should be recorded using a retrospective approach whereby the unearned revenue and refund obligations are remeasured and adjusted at each balance sheet date with the offset being recorded as earned revenue. FN56

FN56 The staff believes deferred costs being amortized on a basis consistent with the deferred revenue should be similarly adjusted. Such an approach is generally consistent with the amortization methodology in ~~Statement 91, paragraph 19 [paragraph 310-20-35-26]~~FASB ASC paragraph 310-20-35-26.

Companies offering memberships often distribute membership packets describing and discussing the terms, conditions, and benefits of membership. Packets may include vouchers, for example, that provide new members with discounts or other benefits from third parties. The costs associated with the vouchers should be expensed when distributed. Advertising costs to solicit members should be accounted for in accordance with ~~SOP 93-7 [Subtopic 720-35]~~FASB ASC Subtopic 720-35, Other Expenses—Advertising Costs. Incremental direct costs incurred in connection with enrolling customers (e. g., commissions paid to agents) should be accounted for as follows: (1) if revenue is deferred until the cancellation or termination privileges expire, incremental direct costs should be either (a) charged to expense when incurred if the costs are not refundable to the company in the event the customer obtains a refund of the

membership fee, or (b) if the costs are refundable to the company in the event the customer obtains a refund of the membership fee, recorded as an asset until the earlier of termination or cancellation or refund; or (2) if revenue, net of estimated refunds, is recognized in earnings over the membership period, a like percentage of incremental direct costs should be deferred and recognized in earnings in the same pattern as revenue is recognized, and the remaining portion should be either (a) charged to expense when incurred if the costs are not refundable to the company in the event the customer obtains a refund of the membership fee, or (b) if the costs are refundable to the company in the event the customer obtains a refund of the membership fee, recorded as an asset until the refund occurs. FN57 All costs other than incremental direct costs (e. g., indirect costs) should be expensed as incurred.

~~FN57 Statement 91, paragraph 5 [paragraph 310-20-25-2] and Technical Bulletin 90-1, paragraph 4 [paragraph 605-20-25-4] FASB ASC paragraphs 310-20-25-2 and 605-20-25-4~~ both provide for the deferral of incremental direct costs associated with acquiring a revenue-producing contract. Even though the revenue discussed in this example is refundable, if a registrant meets the aforementioned criteria for revenue recognition over the membership period, the staff would analogize to this guidance. However, if neither a nonrefundable contract nor a reliable basis for estimating net cash inflows under refundable contracts exists to provide a basis for recovery of incremental direct costs, the staff believes that such costs should be expensed as incurred. See SAB Topic 13.A.3.f. Question 3.

## Question 2.

Question: Will the staff accept an analogy to ~~Statement 48 [Subtopic 605-46] FASB ASC Subtopic 605-15~~ for service transactions subject to customer cancellation privileges other than those specifically addressed in the previous question?

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

~~A~~ leasing broker whose commission from the lessor upon a commercial tenant's signing of a lease agreement is refundable (or in some cases, is not due) under lessor cancellation privileges if the tenant fails to move into the leased premises by a specified date.

~~Aa~~ talent agent whose fee receivable from its principal (i. e., a celebrity) for arranging a celebrity endorsement for a five-year term is cancelable by the celebrity if the celebrity breaches the endorsement contract with its customer.

~~Anan~~ insurance agent whose commission received from the insurer upon selling an insurance policy is refundable in whole for the 30-day period that state law permits the consumer to repudiate the contract and then refundable on a declining pro rata basis until the consumer has made six monthly payments.

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

### Question 3.

Question: Must a registrant analogize to ~~Statement 48 [Subtopic 605-45]~~FASB ASC Subtopic 605-15, or may it choose to defer all revenue until the refund period lapses as suggested by ~~Statement 140 [Subtopic 860-10]~~FASB ASC Topic 860 even if the criteria above for analogy to ~~Statement 48 [Subtopic 605-15]~~FASB ASC Subtopic 605-15 are met?

Interpretive Response: The analogy to ~~Statement 48 [Subtopic 605-45]~~FASB ASC Subtopic 605-15 is presented as an alternative that would be acceptable to the staff when the listed conditions are met. However, a registrant may choose to defer all revenue until the refund period lapses. The policy chosen should be disclosed and applied consistently.

### Question 4.

Question: May a registrant that meets the above criteria for reliable estimates of cancellations choose at some point in the future to change from the ~~Statement 48 [Subtopic 605-15]~~FASB ASC Subtopic 605-15 method to the ~~Statement 140 [Subtopic 860-10]~~FASB ASC Topic 860

method of accounting for these refundable fees? May a registrant change from the ~~Statement 140 [Subtopic 860-10]~~FASB ASC Topic 860 method to the ~~Statement 48 [Subtopic 605-15]~~FASB ASC Subtopic 605-15 method?

Interpretive Response: The staff believes that ~~Statement 140 [Subtopic 860-10]~~FASB ASC Topic 860 provides a preferable accounting model for service transactions subject to potential refunds. Therefore, the staff would not object to a change from the ~~Statement 48 [Subtopic 605-15]~~FASB ASC Subtopic 605-15 method to the ~~Statement 140 [Subtopic 860-10]~~FASB ASC Topic 860 method. However, if a registrant had previously chosen the ~~Statement 140 [Subtopic 860-10]~~FASB ASC Topic 860 method, the staff would object to a change to the ~~Statement 48 [Subtopic 605-15]~~FASB ASC Subtopic 605-15 method.

Question 5.

Question: Is there a minimum level of customers that must be projected not to cancel before use of ~~Statement 48 [Subtopic 605-15]~~FASB ASC Subtopic 605-15 type accounting is appropriate?

Interpretive Response: ~~Statement 48 [Subtopic 605-15]~~FASB ASC Subtopic 605-15 does not include any such minimum. Therefore, the staff does not believe that a minimum must apply in service transactions either. However, as the refund rate increases, it may be increasingly difficult to make reasonable and reliable estimates of cancellation rates.

Question 6.

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

Interpretive Response: Changes in the ability to meet the criteria set forth above should be accounted for in the manner described in ~~paragraph 6 of Statement 48 [paragraph 605-15-25-1]~~FASB ASC paragraph 605-15-25-1, which addresses the accounting when a company experiences a change in the ability to make reasonable estimates of future product returns.

b. Estimates and changes in estimates.

Accounting for revenues and costs of revenues requires estimates in many cases; those estimates sometimes change. Registrants should ensure that

they have appropriate internal controls and adequate books and records that will result in timely identification of necessary changes in estimates that should be reflected in the financial statements and notes thereto.

Question 1.

Facts: ~~Paragraph 8 of Statement 48 [paragraph 605-15-25-3]~~FASB ASC paragraph 605-15-25-3 lists a number of factors that may impair the ability to make a reasonable estimate of product returns in sales transactions when a right of return exists. FN58 The paragraph concludes by stating "other factors may preclude a reasonable estimate."

FN58 These factors include "a) the susceptibility of the product to significant external factors, such as technological obsolescence or changes in demand, b) relatively long periods in which a particular product may be returned, c) absence of historical experience with similar types of sales of similar products, or inability to apply such experience because of changing circumstances, for example, changes in the selling enterprise's marketing policies and relationships with its customers, and d) absence of a large volume of relatively homogeneous transactions."

Question: What "other factors," in addition to those listed in ~~paragraph 8 of Statement 48 [paragraph 605-15-25-3]~~has FASB ASC paragraph 605-15-25-3, have the staff identified that may preclude a registrant from making a reasonable and reliable estimate of product returns?

Interpretive Response: The staff believes that the following additional factors, among others, may affect or preclude the ability to make reasonable and reliable estimates of product returns: (1) significant increases in or excess levels of inventory in a distribution channel (sometimes referred to as "channel stuffing"), (2) lack of "visibility" into or the inability to determine or observe the levels of inventory in a distribution channel and the current level of sales to end users, (3) expected introductions of new products that may result in the technological obsolescence of and larger than expected returns of current products, (4) the significance of a particular distributor to the registrant's (or a reporting segment's) business, sales and marketing, (5) the newness of a product, (6) the introduction of competitors' products with superior technology or greater expected market acceptance, and (7) other factors that affect market demand and changing trends in that demand for the registrant's products. Registrants and their auditors should carefully analyze all factors, including trends in historical data, which may affect registrants' ability to make reasonable and reliable estimates of product returns.

The staff reminds registrants that if a transaction fails to meet all of the conditions of paragraphs 6 and 8 in Statement 48 [paragraphs 605-15-25-1 and 605-15-25-3] FASB ASC paragraphs 605-15-25-1 and 605-15-25-3, no revenue may be recognized until those conditions are subsequently met or the return privilege has substantially expired, whichever occurs first. FN59 Simply deferring recognition of the gross margin on the transaction is not appropriate.

FN59 Statement 48, paragraph 6 [paragraph 605-15-25-1] FASB ASC paragraph 605-15-25-1.

Question 2.

Question: Is the requirement cited in the previous question for "reliable" estimates meant to imply a new, higher requirement than the "reasonable" estimates discussed in Statement 48 [Subtopic 605-15] FASB ASC Subtopic 605-15?

Interpretive Response: No. "Reliability" of financial information is one of the qualities of accounting information discussed in Concepts Statement 2 *Statement 2, Qualitative Characteristics of Accounting Information*. The staff's expectation that estimates be reliable does not change the existing requirement of Statement 48 [Subtopic 605-15] FASB ASC Subtopic 605-15. If management cannot develop an estimate that is sufficiently reliable for use by investors, the staff believes it cannot make a reasonable estimate meeting the requirements of that standard.

Question 3.

Question: Does the staff expect registrants to apply the guidance in Question 1 of Topic 13.A.4(a) above to sales of tangible goods and other transactions specifically within the scope of Statement 48 [Subtopic 605-15] FASB ASC Subtopic 605-15?

Interpretive Response: The specific guidance above does not apply to transactions within the scope of Statement 48 [Subtopic 605-15] FASB ASC Subtopic 605-15. The views set forth in Question 1 of Topic 13.A.4(a) are applicable to the service transactions discussed in that Question. Service transactions are explicitly outside the scope of Statement 48 [Subtopic 605-15] FASB ASC Subtopic 605-15.

Question 4.

Question: Question 1 of Topic 13.A.4(a) above states that the staff would expect a two-year history of selling a new service in order to be able to make reliable estimates of cancellations. How long a history does the staff believe is necessary to estimate returns in a product sale transaction that is within the scope of ~~Statement 48 [Subtopic 605-15]~~FASB ASC Subtopic 605-15?

Interpretive Response: The staff does not believe there is any specific length of time necessary in a product transaction. However, ~~Statement 48 [Subtopic 605-15]~~FASB ASC Subtopic 605-15 states that returns must be subject to reasonable estimation. Preparers and auditors should be skeptical of estimates of product returns when little history with a particular product line exists, when there is inadequate verifiable evidence of historical experience, or when there are inadequate internal controls that ensure the reliability and timeliness of the reporting of the appropriate historical information. Start-up companies and companies selling new or significantly modified products are frequently unable to develop the requisite historical data on which to base estimates of returns.

Question 5.

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

Interpretive Response: No. If a reasonable estimate of future returns cannot be made, ~~Statement 48 [Topic 605]~~FASB ASC Subtopic 605-15 requires that revenue not be recognized until the return period lapses or a reasonable estimate can be made. FN60 Deferring revenue recognition based on the upper end of a wide range of potential return rates is inconsistent with the provisions of ~~Statement 48 [Subtopic 605-15]~~FASB ASC Subtopic 605-15.

FN60 ~~Statement 48, paragraph 6(f) [paragraph 605-15-25-1(f)]~~FASB ASC subparagraph 605-15-25-1(f).

c. Contingent rental income.

Facts: Company A owns and leases retail space to retailers. Company A (lessor) renews a lease with a customer (lessee) that is classified as an

operating lease. The lease term is one year and provides that the lease payments are \$1.2 million, payable in equal monthly installments on the first day of each month, plus one percent of the lessee's net sales in excess of \$25 million if the net sales exceed \$25 million during the lease term (i. e., contingent rental). The lessee has historically experienced annual net sales in excess of \$25 million in the particular space being leased, and it is probable that the lessee will generate in excess of \$25 million net sales during the term of the lease.

Question: In the staff's view, should the lessor recognize any rental income attributable to the one percent of the lessee's net sales exceeding \$25 million before the lessee actually achieves the \$25 million net sales threshold?

Interpretive Response: No. The staff believes that contingent rental income "accrues" (i. e., it should be recognized as revenue) when the changes in the factor(s) on which the contingent lease payments is (are) based actually occur. FN61

FN61 Lessees should follow the guidance established in ~~EITF Issue 98-9~~ Topic 840 FASB ASC Subtopic 840-10.

~~Statement 13 paragraph 19(b) [paragraph 840-20-25-2(b)] FASB ASC paragraph 840-20-25-1 states that lessors should account for operating leases as follows: "Rent shall be reported in income" "[r]ent shall be charged to expense by lessees (reported as income by lessors) over the lease term as it becomes receivable according to the provisions of the lease payable (receivable). However, if the rentals vary from [f rental payments are not made on a straight-line basis, the income rental expense nevertheless shall be recognized on a straight-line basis unless another systematic and rational basis is more representative of the time pattern in which use benefit is derived from the leased property is diminished, in which case that basis shall be used."~~

~~Statement 29 amended Statement 13 [paragraph 840-10-55-11] and FASB ASC paragraph 840-10-25-4 clarifies that "lease payments that depend on a factor that does not exist or is not measurable at the inception of the lease, such as future sales volume, would be contingent rentals in their entirety and, accordingly, would be excluded from minimum lease payments and included in the determination of income as they accrue." [Summary] Paragraph 17 of Statement 29 [paragraph 840-10-55-38] FASB ASC paragraph 840-10-55-38 provides the following example of determining contingent rentals:~~

~~Assume that a lease agreement for retail store space could stipulate~~stipulates a monthly base rental of \$200 and a monthly supplemental rental of one-fourth of one percent of monthly sales volume during the lease term. Even if the lease agreement is a renewal for store space that had averaged monthly sales of \$25,000 for the past 2 years, minimum lease payments would include only the \$200 monthly base rental; the supplemental rental is a contingent rental that is excluded from minimum lease payments. The future sales for the lease term do not exist at the inception of the lease, and future rentals would be limited to \$200 per month if the store were subsequently closed and no sales were made thereafter.

~~Technical Bulletin 85-3~~FASB ASC Section 840-20-25 addresses whether it is appropriate for lessors in operating leases to recognize scheduled rent increases on a basis other than as required in ~~Statement 13, paragraph 19(b)~~FASB ASC paragraph 840-20-25-1. ~~Paragraph 2 of Technical Bulletin 85-3~~FASB ASC subparagraph 840-20-25-2(a) states "using factors such as the time value of money, anticipated inflation, or expected future revenues [emphasis added] to allocate scheduled rent increases is inappropriate because these factors do not relate to the time pattern of the physical usage of the leased property. However, such factors may affect the periodic reported rental income or expense if the lease agreement involves contingent rentals, which are excluded from minimum lease payments and accounted for separately under ~~Statement 13, as amended by Statement 29.~~" In developing the basis for why scheduled rent increases should be recognized on a straight-line basis, the FASB distinguishes the accounting for scheduled rent increases from contingent rentals. ~~Paragraph 13~~FASB ASC subparagraph 840-20-25-2(b) states "There is an important substantive difference between lease rentals that are contingent upon some specified future event and scheduled rent increases that are unaffected by future events; the accounting under ~~Statement 13~~ reflects that difference. If "[i]f the lessor and lessee and lessor eliminate the risk of variable payments inherent in contingent rentals by agreeing to scheduled rent increases, the accounting ~~should~~shall reflect those different circumstances."

The example provided in ~~Statement 29 [paragraph 840-10-55-39]~~FASB ASC paragraph 840-10-55-39 implies that contingent rental income in leases classified as sales-type or direct-financing leases becomes "accruable" when the changes in the factors on which the contingent lease payments are based actually occur. ~~Technical Bulletin 85-3 [Section 840-20-25]~~FASB ASC paragraph 840-20-25-2 indicates that contingent rental income in operating leases should not be recognized in a manner consistent with scheduled rent increases (i. e., on a straight-line basis over the lease term or another systematic and rational allocation basis if it is more representative of the time pattern in which the leased property is

physically employed) because the risk of variable payments inherent in contingent rentals is substantively different than scheduled rent increases. The staff believes that the reasoning in ~~Technical Bulletin 85-3~~ [Section 840-20-25] FASB ASC Section 840-20-25 supports the conclusion that the risks inherent in variable payments associated with contingent rentals should be reflected in financial statements on a basis different than rental payments that adjust on a scheduled basis and, therefore, operating lease income associated with contingent rents would not be recognized as time passes or as the leased property is physically employed. Furthermore, prior to the lessee's achievement of the target upon which contingent rentals are based, the lessor has no legal claims on the contingent amounts. Consequently, the staff believes that it is inappropriate to anticipate changes in the factors on which contingent rental income in operating leases is based and recognize rental income prior to the resolution of the lease contingencies.

Because Company A's contingent rental income is based upon whether the customer achieves net sales of \$25 million, the contingent rentals, which may not materialize, should not be recognized until the customer's net sales actually exceed \$25 million. Once the \$25 million threshold is met, Company A would recognize the contingent rental income as it becomes accruable, in this case, as the customer recognizes net sales. The staff does not believe that it is appropriate to recognize revenue based upon the probability of a factor being achieved. The contingent revenue should be recorded in the period in which the contingency is resolved.

d. Claims processing and billing services.

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

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

Interpretive Response: The staff believes that Company M must wait until collections occur before recognizing revenue. Before the third-party payer has remitted payment to Company M's customers for the services billed,

Company M is not entitled to any revenue. That is, its revenue is not yet realized or realizable. FN62 Until Company M's customers collect on the billings, Company M has not performed the requisite activity under its contract to be entitled to a fee. FN63 Further, no amount of the fee is fixed or determinable or collectible until Company Ms' customers collect on the billings.

FN62 Concepts Statement 5, paragraph 83(a).

FN63 Concepts Statement 5, paragraph 83(b).

SAB Topic 13.B, Disclosures

B. Disclosures.

~~Question 1.~~

Question: What disclosures are required with respect to the recognition of revenue?

Interpretive Response: A registrant should disclose its accounting policy for the recognition of revenue pursuant to ~~Opinion 22 [Subtopic 235-10]~~ FASB ASC Topic 235, Notes to Financial Statements, Paragraph 12 [paragraph 235-10-50-3] ~~FASB ASC paragraph 235-10-50-3~~ thereof states that "the disclosure should encompass important judgments as to appropriateness of principles relating to recognition of revenue...." Because revenue recognition generally involves some level of judgment, the staff believes that a registrant should always disclose its revenue recognition policy. If a company has different policies for different types of revenue transactions, including barter sales, the policy for each material type of transaction should be disclosed. If sales transactions have multiple units of accounting, such as a product and service, the accounting policy should clearly state the accounting policy for each unit of accounting as well as how units of accounting are determined and valued. In addition, the staff believes that changes in estimated returns recognized in accordance with ~~Statement 48 [Subtopic 605-15]~~ FASB ASC Subtopic 605-15 should be disclosed, if material (e. g., a change in estimate from two percent of sales to one percent of sales).

Regulation S-X requires that revenue from the sales of products, services, and other products each be separately disclosed on the face of the income statement. FN64 The staff believes that costs relating to each type of revenue similarly should be reported separately on the face of the income statement.

FN64 See Regulation S-X, ~~Article 5-03(b)(1) and (2)~~Article 5-03(1) and (2).

MD&A requires a discussion of liquidity, capital resources, results of operations and other information necessary to an understanding of a registrant's financial condition, changes in financial condition and results of operations. FN65 This includes unusual or infrequent transactions, known trends or uncertainties that have had, or might reasonably be expected to have, a favorable or unfavorable material effect on revenue, operating income or net income and the relationship between revenue and the costs of the revenue. Changes in revenue should not be evaluated solely in terms of volume and price changes, but should also include an analysis of the reasons and factors contributing to the increase or decrease. The Commission stated in FRR 36 that MD&A should "give investors an opportunity to look at the registrant through the eyes of management by providing a historical and prospective analysis of the registrant's financial condition and results of operations, with a particular emphasis on the registrant's prospects for the future." FN66 Examples of such revenue transactions or events that the staff has asked to be disclosed and discussed in accordance with FRR 36 are:

FN65 See Regulation S-K, Article 303 and FRR 36.

FN66 ~~FRR 36, also see~~FRR 36; see also In the Matter of Caterpillar Inc., AAER 363 (March 31, 1992).

Shipments of product at the end of a reporting period that significantly reduce customer backlog and that reasonably might be expected to result in lower shipments and revenue in the next period.

Granting of extended payment terms that will result in a longer collection period for accounts receivable (regardless of whether revenue has been recognized) and slower cash inflows from operations, and the effect on liquidity and capital resources. (The fair value of trade receivables should be disclosed in the footnotes to the financial statements when the fair value does not approximate the carrying amount.) FN67

FN67 ~~Statement 107 [Subtopic 825-10]~~FASB ASC Subtopic 825-10, Financial Instruments—Overall.

Changing trends in shipments into, and sales from, a sales channel or separate class of customer that could be expected to have a significant effect on future sales or sales returns.

An increasing trend toward sales to a different class of customer, such as a reseller distribution channel that has a lower gross profit margin than existing sales that are principally made to end users. Also, increasing service revenue that has a higher profit margin than product sales.

Seasonal trends or variations in sales.

A gain or loss from the sale of an asset(s). FN68

FN68 Gains or losses from the sale of assets should be reported as "other general expenses" pursuant to Regulation S-X, ~~Article 5-03(b)(6)~~ Article 5-03(6). Any material item should be stated separately.

~~Question 2:~~

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

~~Interpretive Response: All registrants are expected to apply the accounting and disclosures described in this bulletin. The staff, however, will not object if registrants that have not applied this accounting do not restate prior financial statements provided they report a change in accounting principle in accordance with Opinion 20 and Statement 3 [Subtopic 250-10] no later than the fourth fiscal quarter of the fiscal year beginning after December 15, 1999. In periods subsequent to transition, registrants should disclose the amount of revenue (if material to income before income taxes) recognized in those periods that was included in the cumulative effect adjustment. If a registrant files financial statements with the Commission before applying the guidance in this bulletin, disclosures similar to those described in SAB Topic 11.M should be provided.~~

~~However, if registrants have not previously complied with GAAP, for example, by recording revenue for products prior to delivery that did not comply with the applicable bill and hold guidance, those registrants should apply the guidance in Opinion 20 [Subtopic 250-10] for the correction of an error. FN69 In addition, registrants should be aware that the Commission may take enforcement action where a registrant in prior financial statements has violated the antifraud or disclosure provisions of the securities laws with respect to revenue recognition.~~

~~FN69 Opinion 20, paragraph 13 and paragraphs 36-37 [paragraphs 250-10-45-23 and 250-10-50-7 through 50-11] describe and provide the accounting and disclosure requirements applicable to the correction of an error in previously issued financial statements.~~

~~Because the term "error" as used in Opinion 20 [Subtopic 250-10] includes "oversight or misuse of facts that existed at the time that the financial statements were prepared," that term includes both unintentional errors as well as intentional fraudulent financial reporting and misappropriation of assets as described in SAS 99.~~

#### ~~Question 3-~~

~~Question: The previous question indicates that the staff will not object to cumulative effect type transition so long as the prior accounting does not represent an error. Could a company whose prior accounting does not represent an error voluntarily adopt a new method consistent with this SAB Topic by restatement of prior periods, rather than through a cumulative catch-up adjustment?~~

~~Interpretive Response: In most instances, no. Opinion 20 does not permit restatement of financial statements for a change in accounting principle that does not represent correction of an error, except in very rare circumstances. FN70 An exception is a company that is filing publicly for the first time. As stated in paragraph 29 of Opinion 20, those companies are permitted to reflect the adoption of the new policy via a restatement, and the staff believes that approach is usually necessary to avoid confusing investors in an initial public offering.~~

~~FN70 See, for example, Opinion 20, paragraph 27.~~

#### ~~Question 4-~~

~~Question: Should a registrant reporting a change in accounting principle as a result of this SAB Topic file a preferability letter?~~

~~Interpretive Response: No preferability letter is required if an accounting change is made in response to a newly issued Staff Accounting Bulletin.~~

#### ~~Question 5-~~

~~Question: If a company had not previously adjusted sales revenues, but deferred recognition of the gross margin of estimated returns for a transaction subject to Statement 48 [Subtopic 605-15], how should it present a current change in accounting to reduce revenue and cost of sales for estimated returns?~~

~~Interpretive Response: Paragraph 7 of Statement 48 [paragraph 605-15 45-1] states that "sales revenue and cost of sales reported in the income~~

~~statement shall be reduced to reflect estimated returns." Statement 48 [Subtopic 605-15] does not provide for recognition of sales and costs of sales while deferring gross margin under any circumstance. This SAB Topic provides no new guidance on this point. If a registrant has failed to comply with GAAP, the registrant should retroactively revise prior financial statements in the manner set forth in Opinion 20 and Statement 16 [Subtopic 250-10].~~

21. Amend paragraph 605-15-S99-2, with no link to a transition paragraph, as follows:

## **Revenue Recognition—Products**

### **SEC Materials**

#### **> SEC Staff Guidance**

#### **> > Staff Accounting Bulletins**

#### **> > > SAB Topic 8, Retail Companies**

#### **> > > > SAB Topic 8.A, Sales of Leased or Licensed Departments**

**605-15-S99-2** The following is the text of SAB Topic 8.A, Sales of Leased or Licensed Departments.

Facts: At times, department stores and other retailers have included the sales of leased or licensed departments in the amount reported as "total revenues."

Question: Does the staff have any objection to this practice?

Interpretive Response: ~~In November 1975 the staff issued SAB 1 that addressed this issue. In that SAB the staff did not object to retailers presenting sales of leased or licensed departments in the amount reported as "total revenues" because of industry practice. Subsequently, in November 1976 the FASB issued Statement 13 [Topic 840]. In June 1995, the AICPA staff amended its Technical Practice Aid (TPA) section 5100.16 based upon an interpretation of Statement 13 [Topic 840] that leases of departments within a retail establishment are leases of tangible assets within the scope of Statement 13 [Topic 840]. FN1 Consistent with the interpretation in TPA section 5100.16, the~~The staff believes that Statement 13 [Topic 840] FASB ASC Topic 840, Leases, requires department stores and other retailers that lease or license store space to account for rental

income from leased departments in accordance with ~~Statement 13 [Topic 840]~~FASB ASC Topic 840. Accordingly, it would be inappropriate for a department store or other retailer to include in its revenue the sales of the leased or licensed departments. Rather, the department store or other retailer should include the rental income as part of its gross revenue.

The staff would not object to disclosure in the footnotes to the financial statements of the amount of the lessee's sales from leased departments.

If the arrangement is not a lease but rather a service arrangement that provides for payment of a fee or commission, the retailer should recognize the fee or commission as revenue when earned. If the retailer assumes the risk of bad debts associated with the lessee's merchandise sales, the retailer generally should present bad debt expense in accordance with ~~Rule 5-03(b)(5)~~Rule 5-03 of Regulation S-X.

FN1 ~~Statement 13, paragraph 1 [the FASB Codification Glossary: Lease]~~The FASB ASC Master Glossary defines a lease as "the "an agreement conveying the right to use property, plant, or equipment (land or and/or depreciable assets or both) usually for a stated period of time."

22. Amend paragraph 718-10-S99-1, with no link to a transition paragraph, as follows:

## **Compensation—Stock Compensation—Overall**

### **SEC Materials**

#### **> SEC Staff Guidance**

#### **> > Staff Accounting Bulletins**

#### **> > > SAB Topic 14, Share-Based Payment**

**718-10-S99-1** The following is the text of SAB Topic 14, Share-Based Payment.

The interpretations in this SAB express views of the staff regarding the interaction between ~~Statement 123R [Topic 718]~~FASB ASC Topic 718, Compensation—Stock Compensation, and certain SEC rules and regulations and provide the staff's views regarding the valuation of share-based payment arrangements for public companies. ~~Statement 123R was issued by the Financial Accounting Standards Board (FASB) on December 16, 2004. Statement 123R [Topic 718]~~FASB ASC Topic 718 is based on the

underlying accounting principle that compensation cost resulting from share-based payment transactions be recognized in financial statements at fair value. FN1 Recognition of compensation cost at fair value will provide investors and other users of financial statements with more complete and comparable financial information. FN2

~~FN1 Statement 123R, paragraph 4~~FASB ASC paragraphs 718-10-30-2 through 718-10-30-4.

~~FN2 Statement 123R, page iv.~~[Original footnote removed by SAB 114.]

~~Statement 123R [Topic 718]~~FASB ASC Topic 718 addresses a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans.

~~Statement 123R [Topic 718]~~FASB ASC Topic 718 replaces ~~Statement 123 and supersedes Opinion 25. Statement 123,~~guidance as originally issued in 1995, that established as preferable, but did not require, a fair-value-based method of accounting for share-based payment transactions with employees.

The staff believes the guidance in this SAB will assist issuers in their initial implementation of ~~Statement 123R~~FASB ASC Topic 718 and enhance the information received by investors and other users of financial statements, thereby assisting them in making investment and other decisions. This SAB includes interpretive guidance related to share-based payment transactions with nonemployees, the transition from nonpublic to public entity FN3 status, valuation methods (including assumptions such as expected volatility and expected term), the accounting for certain redeemable financial instruments issued under share-based payment arrangements, the classification of compensation expense, non-GAAP financial measures, first-time adoption of ~~Statement 123R~~FASB ASC Topic 718 in an interim period, capitalization of compensation cost related to share-based payment arrangements, the accounting for income tax effects of share-based payment arrangements upon adoption of ~~Statement 123R~~FASB ASC Topic 718, the modification of employee share options prior to adoption of ~~Statement 123R~~FASB ASC Topic 718 and disclosures in MD&A subsequent to adoption of ~~Statement 123R~~FASB ASC Topic 718.

FN3 Defined in ~~Statement 123R, Appendix E~~the FASB ASC Master Glossary.

The staff recognizes that there is a range of conduct that a reasonable issuer might use to make estimates and valuations and otherwise implement ~~Statement 123R~~FASB ASC Topic 718, and the interpretive guidance provided by this SAB, particularly during the period of the ~~Topic's~~Statements initial implementation. Thus, throughout this SAB the use of the terms ~~reasonable~~ "reasonable" and ~~reasonably~~ "reasonably" is not meant to imply a single conclusion or methodology, but to encompass the full range of potential conduct, conclusions or methodologies upon which an issuer may reasonably base its valuation decisions. Different conduct, conclusions or methodologies by different issuers in a given situation does not of itself raise an inference that any of those issuers is acting unreasonably. While the zone of reasonable conduct is not unlimited, the staff expects that it will be rare when there is only one acceptable choice in estimating the fair value of share-based payment arrangements under the provisions of ~~Statement 123R~~ [Topic 718]FASB ASC Topic 718 and the interpretive guidance provided by this SAB in any given situation. In addition, as discussed in the Interpretive Response to Question 1 of Section C, Valuation Methods, estimates of fair value are not intended to predict actual future events, and subsequent events are not indicative of the reasonableness of the original estimates of fair value made under ~~Statement 123R~~ [Topic 718]FASB ASC Topic 718. Over time, as issuers and accountants gain more experience in applying ~~Statement 123R~~ [Topic 718]FASB ASC Topic 718 and the guidance provided in this SAB, the staff anticipates that particular approaches may begin to emerge as best practices and that the range of reasonable conduct, conclusions and methodologies will likely narrow.

#### SAB Topic 14.A, Share-based Payment Transactions with Nonemployees

Question: Are share-based payment transactions with nonemployees included in the scope of ~~Statement 123R~~ [Topic 718]FASB ASC Topic 718?

Interpretive Response: Only certain aspects of the accounting for share-based payment transactions with nonemployees are explicitly addressed by ~~Statement 123R~~ [Topic 718]FASB ASC Topic 718. ~~Statement 123R~~ [Topic 718]This Topic explicitly:

Establishes fair value as the measurement objective in accounting for all share-based payments; FN4 ~~and~~and

FN4 ~~Statement 123R, paragraph 7~~ [paragraph 718-10-30-2]FASB ASC paragraph 718-10-30-2.

Requires that an entity record the value of a transaction with a nonemployee based on the more reliably measurable fair value of either the good or service received or the equity instrument issued. FN5

FN5 Ibid.

~~Statement 123R [Topic 718]FASB ASC Topic 718~~ does not supersede any of the authoritative literature that specifically addresses accounting for share-based payments with nonemployees. For example, ~~Statement 123R [Topic 718]FASB ASC Topic 718~~ does not specify the measurement date for share-based payment transactions with nonemployees when the measurement of the transaction is based on the fair value of the equity instruments issued. FN6 For determining the measurement date of equity instruments issued in share-based transactions with nonemployees, a company should refer to ~~Emerging Issues Task Force (EITF) Issue No. 96-18, Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services [Topic 505]FASB ASC Subtopic 505-50, Equity—Equity-Based Payments to Non-Employees.~~

FN6 ~~Statement 123R, paragraph 8.[Original footnote removed by SAB 114.]~~

With respect to questions regarding nonemployee arrangements that are not specifically addressed in other authoritative literature, the staff believes that the application of guidance in ~~Statement 123R [Topic 718]FASB ASC Topic 718~~ would generally result in relevant and reliable financial statement information. As such, the staff believes it would generally be appropriate for entities to apply the guidance in ~~Statement 123R [Topic 718]FASB ASC Topic 718~~ by analogy to share-based payment transactions with nonemployees unless other authoritative accounting literature more clearly addresses the appropriate accounting, or the application of the guidance in ~~Statement 123R [Topic 718]FASB ASC Topic 718~~ would be inconsistent with the terms of the instrument issued to a nonemployee in a share-based payment arrangement. FN7 For example, the staff believes the guidance in ~~Statement 123R [Topic 718]FASB ASC Topic 718~~ on certain transactions with related parties or other holders of an economic interest in the entity would generally be applicable to share-based payment transactions with nonemployees. The staff encourages registrants that have additional questions related to accounting for share-based payment transactions with nonemployees to discuss those questions with the staff.

FN7 For example, due to the nature of specific terms in employee share options, including nontransferability, nonhedgability and the truncation of the contractual term due to post-vesting service

termination, ~~Statement 123R [Topic 718]~~FASB ASC Topic 718 requires that when valuing an employee share option under the Black-Scholes-Merton framework, the fair value of an employee share option be based on the options expected term rather than the contractual term. If these features (i. e., nontransferability, nonhedgability and the truncation of the contractual term) were not present in a nonemployee share option arrangement, the use of an expected term assumption shorter than the contractual term would generally not be appropriate in estimating the fair value of the nonemployee share options.

#### SAB Topic 14.B, Transition from Nonpublic to Public Entity Status

Facts: Company A is a nonpublic entity FN8 that first files a registration statement with the SEC to register its equity securities for sale in a public market on January 2, 20X8. FN9 As a nonpublic entity, Company A had been assigning value to its share options FN10 under the calculated value method prescribed by ~~Statement 123R [Topic 718]~~FASB ASC Topic 718, Compensation—Stock Compensation, FN11 and had elected to measure its liability awards based on intrinsic value. Company A is considered a public entity on January 2, 20X8 when it makes its initial filing with the SEC in preparation for the sale of its shares in a public market.

FN8 Defined in ~~Statement 123R, Appendix E~~the FASB ASC Master Glossary.

FN9 For the purposes of these illustrations, assume all of Company A's equity-based awards granted to its employees were granted after the adoption of ~~Statement 123R~~FASB ASC Topic 718.

FN10 For purposes of this staff accounting bulletin, the phrase ~~share options~~ "share options" is used to refer to ~~share options or similar instruments~~. "share options or similar instruments."

FN11 ~~Statement 123R, paragraph 23 [paragraph 718-10-30-20]~~FASB ASC paragraph 718-10-30-20 requires a nonpublic entity to use the calculated value method when it is not able to reasonably estimate the fair value of its equity share options and similar instruments because it is not practicable for it to estimate the expected volatility of its share price. ~~Statement 123R, paragraph A43 [paragraph 718-10-55-51]~~FASB ASC paragraph 718-10-55-51 indicates that a nonpublic entity may be able to identify similar public entities for which share or option price information is available and may consider the historical, expected, or implied volatility of those entities share prices in estimating expected volatility. The staff would expect an entity that becomes a public entity and had previously measured its share

options under the calculated value method to be able to support its previous decision to use calculated value and to provide the disclosures required by ~~paragraph A240(e)(2)(b) of Statement 123R [paragraph 718-10-50-2(f)(2)(ii)]~~ FASB ASC subparagraph 718-10-50-2(f)(2)(ii).

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

Interpretive Response: Prior to becoming a public entity, Company A had been assigning value to its share options under the calculated value method. The staff believes that Company A should continue to follow that approach for those share options that were granted prior to January 2, 20X8, unless those share options are subsequently modified, repurchased or cancelled. FN12 If the share options are subsequently modified, repurchased or cancelled, Company A would assess the event under the public company provisions of ~~Statement 123R [Topic 718]~~ FASB ASC Topic 718. For example, if Company A modified the share options on February 1, 20X8, any incremental compensation cost would be measured under ~~Statement 123R, paragraph 51(a) [paragraph 718-20-35-3(a)]~~ FASB ASC subparagraph 718-220-35-3(a), as the fair value of the modified share options over the fair value of the original share options measured immediately before the terms were modified. FN13

FN12 This view is consistent with the FASB's basis for rejecting full retrospective application of ~~Statement 123R~~ FASB ASC Topic 718 as described in the basis for conclusions of Statement 123R, paragraph B251.

FN13 ~~Statement 123R, footnote 103 [paragraph 718-20-55-94]~~ FASB ASC paragraph 718-20-55-94. The staff believes that because Company A is a public entity as of the date of the modification, it would be inappropriate to use the calculated value method to measure the original share options immediately before the terms were modified.

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

Interpretive Response: As a nonpublic entity, Company A had elected to measure its liability awards subject to ~~Statement 123R [Topic 718]~~ FASB ASC Topic 718 at intrinsic value. FN14 When Company A becomes a public entity, it should measure the liability awards at their fair value determined in accordance with ~~Statement 123R [Topic 718]~~ FASB ASC

Topic 718. FN15 In that reporting period there will be an incremental amount of measured cost for the difference between fair value as determined under ~~Statement 123R [Topic 718]~~ FASB ASC Topic 718 and intrinsic value. For example, assume the intrinsic value in the period ended December 31, 20X7 was \$10 per award. At the end of the first reporting period ending after January 2, 20X8 (when Company A becomes a public entity), assume the intrinsic value of the award is \$12 and the fair value as determined in accordance with ~~Statement 123R [Topic 718]~~ FASB ASC Topic 718 is \$15. The measured cost in the first reporting period after December 31, 20X7 would be \$5. FN16

FN14 ~~Statement 123R, paragraph 38 [paragraph 718-30-30-2]~~ FASB ASC paragraph 718-30-30-2.

FN15 ~~Statement 123R, paragraph 37 [paragraph 718-30-35-3]~~ FASB ASC paragraph 718-30-35-3.

FN16 \$15 fair value less \$10 intrinsic value equals \$5 of incremental cost.

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

Interpretive Response: No. Before becoming a public entity, Company A did not use the fair-value-based method for either its share options or its liability awards granted to the Company's employees. The staff does not believe it is appropriate for Company A to apply the fair-value-based method on a retrospective basis, because it would require the entity to make estimates of a prior period, which, due to hindsight, may vary significantly from estimates that would have been made contemporaneously in prior periods. FN17

FN17 This view is consistent with the FASB's basis for rejecting full retrospective application of ~~Statement 123R~~ FASB ASC Topic 718 as described in the basis for conclusions of Statement 123R, paragraph B251.

Question 4: Upon becoming a public entity, what disclosures should Company A consider in addition to those prescribed by ~~Statement 123R [Topic 718]~~ FASB ASC Topic 718? FN18

FN18 ~~Statement 123R disclosure requirements are described in paragraphs 64, 65, A240, A241 and A242 [Section 718-10-50]~~ FASB ASC Section 718-10-50.

Interpretive Response: In the registration statement filed on January 2, 20X8, Company A should clearly describe in MD&A the change in accounting policy that will be required by ~~Statement 123R [Topic 718]~~FASB ASC Topic 718 in subsequent periods and the reasonably likely material future effects. FN19 In subsequent filings, Company A should provide financial statement disclosure of the effects of the changes in accounting policy. In addition, Company A should consider the applicability of SEC Release No. FR-60 FN20 and Section V, ~~Critical Accounting Estimates,~~ “Critical Accounting Estimates,” in SEC Release No. FR-72 FN21 regarding critical accounting policies and estimates in MD&A.

FN19 See generally SEC Release No. FR-72, ~~Commission “Commission Guidance Regarding ManagementsManagement’s Discussion and Analysis of Financial Condition and Results of Operations.Operations.”~~

FN20 SEC Release No. FR-60, ~~Cautionary “Cautionary Advice Regarding Disclosure About Critical Accounting Policies.Policies.”~~

FN21 SEC Release No. FR-72, ~~Commission “Commission Guidance Regarding ManagementsManagement’s Discussion and Analysis of Financial Condition and Results of Operations.Operations.”~~

#### SAB Topic 14.C, Valuation Methods

~~Statement 123R, paragraph 16 [paragraph 718-10-30-6], FASB ASC paragraph 718-10-30-6 (Compensation—Stock Compensation Topic)~~ indicates that the measurement objective for equity instruments awarded to employees is to estimate at the grant date the fair value of the equity instruments the entity is obligated to issue when employees have rendered the requisite service and satisfied any other conditions necessary to earn the right to benefit from the instruments. The ~~TopicStatement~~ also states that observable market prices of identical or similar equity or liability instruments in active markets are the best evidence of fair value and, if available, should be used as the basis for the measurement for equity and liability instruments awarded in a share-based payment transaction with employees. FN22 However, if observable market prices of identical or similar equity or liability instruments are not available, the fair value shall be estimated by using a valuation technique or model that complies with the measurement objective, as described in ~~Statement 123RFASB ASC Topic 718.~~ FN23

FN22 ~~Statement 123R, paragraph A7 [paragraph 718-10-55-10] FASB ASC paragraph 718-10-55-10.~~

FN23 Statement 123R, paragraph A8 [paragraph 718-10-55-11]FASB ASC paragraph 718-10-55-11.

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

Interpretive Response: The staff understands that estimates of fair value of employee share options, while derived from expected value calculations, cannot predict actual future events. FN24 The estimate of fair value represents the measurement of the cost of the employee services to the company. The estimate of fair value should reflect the assumptions marketplace participants would use in determining how much to pay for an instrument on the date of the measurement (generally the grant date for equity awards). For example, valuation techniques used in estimating the fair value of employee share options may consider information about a large number of possible share price paths, while, of course, only one share price path will ultimately emerge. If a company makes a good faith fair value estimate in accordance with the provisions of Statement 123R [Topic 718]FASB ASC Topic 718 in a way that is designed to take into account the assumptions that underlie the instruments value that marketplace participants would reasonably make, then subsequent future events that affect the instruments value do not provide meaningful information about the quality of the original fair value estimate. As long as the share options were originally so measured, changes in an employee share options value, no matter how significant, subsequent to its grant date do not call into question the reasonableness of the grant date fair value estimate.

FN24 Statement 123R, paragraph A12 [paragraph 718-10-55-15]FASB ASC paragraph 718-10-55-15 states The "The fair value of those instruments at a single point in time is not a forecast of what the estimated fair value of those instruments may be in the future-future."

Question 2: In order to meet the fair value measurement objective in Statement 123R [Topic 718]FASB ASC Topic 718, are certain valuation techniques preferred over others?

Interpretive Response: Statement 123R, paragraph A14 [paragraph 718-10-55-17]FASB ASC paragraph 718-10-55-17 clarifies that the StatementTopic does not specify a preference for a particular valuation technique or model. As stated in Statement 123R, paragraph A8 [paragraph 718-10-55-11]FASB ASC paragraph 718-10-55-11 in order to meet the fair value measurement objective, a company should select a valuation

technique or model that (a) is applied in a manner consistent with the fair value measurement objective and other requirements of ~~Statement 123R [Topic 718]~~ FASB ASC Topic 718, (b) is based on established principles of financial economic theory and generally applied in that field and (c) reflects all substantive characteristics of the instrument.

The chosen valuation technique or model must meet all three of the requirements stated above. In valuing a particular instrument, certain techniques or models may meet the first and second criteria but may not meet the third criterion because the techniques or models are not designed to reflect certain characteristics contained in the instrument. For example, for a share option in which the exercisability is conditional on a specified increase in the price of the underlying shares, the Black-Scholes-Merton closed-form model would not generally be an appropriate valuation model because, while it meets both the first and second criteria, it is not designed to take into account that type of market condition. FN25

FN25 See ~~Statement 123R, paragraphs A13-17 [paragraphs 718-10-55-16 through 55-20]~~ FASB ASC paragraphs 718-10-55-16 and 718-10-55-20.

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

Question 3: In subsequent periods, may a company change the valuation technique or model chosen to value instruments with similar characteristics? FN26

FN26 ~~Statement 123R, paragraph A14 and footnote 49 [paragraph 718-10-55-17], indicate~~ FASB ASC paragraph 718-10-55-17 indicates that an entity may use different valuation techniques or models for instruments with different characteristics.

Interpretive Response: As long as the new technique or model meets the fair value measurement objective in ~~Statement 123R [Topic 718]~~ as described in Question 2 above, the staff would not object to a company changing its valuation technique or model. FN27 A change in the valuation technique or model used to meet the fair value measurement objective would not be considered a change in accounting principle. As such, a

company would not be required to file a preferability letter from its independent accountants as described in Rule 10-01(b)(6) of Regulation S-X when it changes valuation techniques or models. FN28 However, the staff would not expect that a company would frequently switch between valuation techniques or models, particularly in circumstances where there was no significant variation in the form of share-based payments being valued. ~~**{delete paragraph return}**~~ Disclosure in the footnotes of the basis for any change in technique or model would be appropriate. FN29

FN27 The staff believes that a company should take into account the reason for the change in technique or model in determining whether the new technique or model meets the fair value measurement objective. For example, changing a technique or model from period to period for the sole purpose of lowering the fair value estimate of a share option would not meet the fair value measurement objective of the ~~Statement Topic~~.

FN28 ~~Statement 123R, paragraph A23 [paragraph 718-10-55-27]~~FASB ASC paragraph 718-10-55-27.

FN29 See generally ~~Statement 123R, paragraph 64c [paragraph 718-10-50-1]~~FASB ASC paragraph 718-10-50-1.

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

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

SAB Topic 14.D, Certain Assumptions Used in Valuation Methods

~~Statement 123R's [Topic 718]~~FASB ASC Topic 718's ~~(Compensation—Stock Compensation Topic)~~ fair value measurement objective for equity instruments awarded to employees is to estimate the grant-date fair value of the equity instruments that the entity is obligated to issue when employees have rendered the requisite service and satisfied any other conditions necessary to earn the right to benefit from the instruments. FN30 In order to meet this fair value measurement objective, management will be required to develop estimates regarding the expected volatility of its company's share price and the exercise behavior of its employees. The staff is providing guidance in the following sections related to the expected

volatility and expected term assumptions to assist public entities in applying those requirements.

~~FN30 Statement 123R, paragraph A2 [paragraph 718-10-55-4]FASB ASC paragraph 718-10-55-4.~~

The staff understands that companies may refine their estimates of expected volatility and expected term as a result of the guidance provided in ~~Statement 123R [Topic 718]FASB ASC Topic 718~~ and in sections (1) and (2) below. ~~{delete paragraph return}~~ Changes in assumptions during the periods presented in the financial statements should be disclosed in the footnotes. FN31

~~FN31 Statement 123R, paragraph A240(e) [paragraph 718-10-55-2]FASB ASC paragraph 718-10-50-2.~~

## 1. Expected Volatility

~~Statement 123R, paragraph A31 [paragraph 718-10-55-36], states, Volatility~~FASB ASC paragraph 718-10-55-36 states, "Volatility is a measure of the amount by which a financial variable, such as share price, has fluctuated (historical volatility) or is expected to fluctuate (expected volatility) during a period. Option-pricing models require an estimate of expected volatility as an assumption because an options value is dependent on potential share returns over the options term. The higher the volatility, the more the returns on the share can be expected to ~~vary~~—up or down. Because an options value is unaffected by expected negative returns on the shares, other things [being] equal, an option on a share with higher volatility is worth more than an option on a share with lower ~~volatility~~." volatility."

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

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

Interpretive Response: ~~Statement 123R [Topic 718]FASB ASC Topic 718~~ does not specify a particular method of estimating expected volatility. However, the ~~Statement~~Topic does clarify that the objective in estimating expected volatility is to ascertain the assumption about expected volatility that marketplace participants would likely use in determining an exchange price for an option. FN32 ~~Statement 123R [Topic 718]FASB ASC Topic 718~~

provides a list of factors entities should consider in estimating expected volatility. FN33 Company B may begin its process of estimating expected volatility by considering its historical volatility. FN34 However, Company B should also then consider, based on available information, how the expected volatility of its share price may differ from historical volatility. FN35 Implied volatility FN36 can be useful in estimating expected volatility because it is generally reflective of both historical volatility and expectations of how future volatility will differ from historical volatility.

~~FN32 Statement 123R, paragraph B86 [paragraph 718-10-55-35] FASB ASC paragraph 718-10-55-35.~~

~~FN33 Statement 123R, paragraph A32 [paragraph 718-10-55-37] FASB ASC paragraph 718-10-55-37.~~

~~FN34 Statement 123R, paragraph A34 [paragraph 718-10-55-40] FASB ASC paragraph 718-10-55-40.~~

FN35 Ibid.

FN36 Implied volatility is the volatility assumption inherent in the market prices of a company's traded options or other financial instruments that have option-like features. Implied volatility is derived by entering the market price of the traded financial instrument, along with assumptions specific to the financial options being valued, into a model based on a constant volatility estimate (e. g., the Black-Scholes-Merton closed-form model) and solving for the unknown assumption of volatility.

The staff believes that companies should make good faith efforts to identify and use sufficient information in determining whether taking historical volatility, implied volatility or a combination of both into account will result in the best estimate of expected volatility. The staff believes companies that have appropriate traded financial instruments from which they can derive an implied volatility should generally consider this measure. The extent of the ultimate reliance on implied volatility will depend on a company's facts and circumstances; however, the staff believes that a company with actively traded options or other financial instruments with embedded options FN37 generally could place greater (or even exclusive) reliance on implied volatility. (See the Interpretive Responses to Questions 3 and 4 below.)

FN37 The staff believes implied volatility derived from embedded options can be utilized in determining expected volatility if, in deriving the implied volatility, the company considers all relevant features of

the instruments (e. g., value of the host instrument, value of the option, etc.). The staff believes the derivation of implied volatility from other than simple instruments (e. g., a simple convertible bond) can, in some cases, be impracticable due to the complexity of multiple features.

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

Question 2: What should Company B consider if computing historical volatility? FN38

FN38 See ~~Statement 123R, paragraph A32 [paragraph 718-10-55-37]~~FASB ASC paragraph 718-10-55-37.

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

#### 1. Method of Computing Historical Volatility

The staff believes the method selected by Company B to compute its historical volatility should produce an estimate that is representative of Company B's expectations about its future volatility over the expected (if using a Black-Scholes-Merton closed-form model) or contractual (if using a lattice model) term FN39 of its employee share options. Certain methods may not be appropriate for longer term employee share options if they weight the most recent periods of Company B's historical volatility much more heavily than earlier periods. FN40 For example, a method that applies a factor to certain historical price intervals to reflect a decay or loss of relevance of that historical information emphasizes the most recent historical periods and thus would likely bias the estimate to this recent history. FN41

FN39 For purposes of this staff accounting bulletin, the phrase *expected or contractual term, as applicable* has the same meaning as the phrase *expected (if using a Black-Scholes-Merton closed-form model) or contractual (if using a lattice model) term of an employee share option*.

FN40 ~~Statement 123R, paragraph A32(a) [paragraph 718-10-55-37(a)]~~FASB ASC subparagraph 718-10-55-37(a) states that entities

should consider historical volatility over a period generally commensurate with the expected or contractual term, as applicable, of the share option. Accordingly, the staff believes methods that place extreme emphasis on the most recent periods may be inconsistent with this guidance.

FN41 Generalized Autoregressive Conditional Heteroskedasticity (GARCH) is an example of a method that demonstrates this characteristic.

## 2. Amount of Historical Data

~~Statement 123R, paragraph A32(a) [paragraph 718-10-55-37(a)], FASB ASC subparagraph 718-10-55-37(a)~~ indicates entities should consider historical volatility over a period generally commensurate with the expected or contractual term, as applicable, of the share option. The staff believes Company B could utilize a period of historical data longer than the expected or contractual term, as applicable, if it reasonably believes the additional historical information will improve the estimate. For example, assume Company B decided to utilize a Black-Scholes-Merton closed-form model to estimate the value of the share options granted on January 2, 20X6 and determined that the expected term was six years. Company B would not be precluded from using historical data longer than six years if it concludes that data would be relevant.

## 3. Frequency of Price Observations

~~Statement 123R, paragraph A32(d) [paragraph 718-10-55-37(d)], FASB ASC subparagraph 718-10-55-37(d)~~ indicates an entity should use appropriate and regular intervals for price observations based on facts and circumstances that provide the basis for a reasonable fair value estimate. Accordingly, the staff believes Company B should consider the frequency of the trading of its shares and the length of its trading history in determining the appropriate frequency of price observations. The staff believes using daily, weekly or monthly price observations may provide a sufficient basis to estimate expected volatility if the history provides enough data points on which to base the estimate. FN42 Company B should select a consistent point in time within each interval when selecting data points. FN43

FN42 Further, if shares of a company are thinly traded the staff believes the use of weekly or monthly price observations would generally be more appropriate than the use of daily price observations. The volatility calculation using daily observations for such shares could be artificially inflated due to a larger spread

between the bid and asked quotes and lack of consistent trading in the market.

~~FN43 Statement 123R, paragraph A34 [paragraph 718-10-55-40], FASB ASC paragraph 718-10-55-40 states that a company should establish a process for estimating expected volatility and apply that process consistently from period to period. In addition, Statement 123R, paragraph A23 [paragraph 718-10-55-27], FASB ASC paragraph 718-10-55-27 indicates that assumptions used to estimate the fair value of instruments granted to employees should be determined in a consistent manner from period to period.~~

#### 4. Consideration of Future Events

The objective in estimating expected volatility is to ascertain the assumptions that marketplace participants would likely use in determining an exchange price for an option. FN44 Accordingly, the staff believes that Company B should consider those future events that it reasonably concludes a marketplace participant would also consider in making the estimation. For example, if Company B has recently announced a merger with a company that would change its business risk in the future, then it should consider the impact of the merger in estimating the expected volatility if it reasonably believes a marketplace participant would also consider this event.

~~FN44 Statement 123R, paragraph B86 [paragraph 718-10-55-35], FASB ASC paragraph 718-10-55-35.~~

#### 5. Exclusion of Periods of Historical Data

In some instances, due to a company's particular business situations, a period of historical volatility data may not be relevant in evaluating expected volatility. FN45 In these instances, that period should be disregarded. The staff believes that if Company B disregards a period of historical volatility, it should be prepared to support its conclusion that its historical share price during that previous period is not relevant to estimating expected volatility due to one or more discrete and specific historical events and that similar events are not expected to occur during the expected term of the share option. The staff believes these situations would be rare.

~~FN45 Statement 123R, paragraph A32(a) [paragraph 718-10-55-37(a)], FASB ASC paragraph 718-10-55-37.~~

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

Interpretive Response: To achieve the objective of estimating expected volatility as stated in ~~paragraph B86 of Statement 123R [paragraphs 718-10-55-35 through 55-41]~~FASB ASC paragraphs 718-10-55-35 through 718-10-55-41, the staff believes Company B generally should consider the following in its evaluation:

- 1) the volume of market activity of the underlying shares and traded options;
- 2) the ability to synchronize the variables used to derive implied volatility;
- 3) the similarity of the exercise prices of the traded options to the exercise price of the employee share options; and
- 4) the similarity of the length of the term of the traded and employee share options. FN46

FN46 See generally *Options, Futures, and Other Derivatives* by John C. Hull (Prentice Hall, 5th Edition, 2003).

#### 1. Volume of Market Activity

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

#### 2. Synchronization of the Variables

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

#### 3. Similarity of the Exercise Prices

The staff believes that when valuing an at-the-money employee share option, the implied volatility derived from at- or near-the-money traded options generally would be most relevant. FN47 If, however, it is not possible to find at- or near-the-money traded options, Company B should select multiple traded options with an average exercise price close to the exercise price of the employee share option. FN48

FN47 Implied volatilities of options differ systematically over the ~~moneyness~~ “moneyness” of the option. This pattern of implied volatilities across exercise prices is known as the ~~volatility smile~~ “volatility smile” or ~~volatility skew~~ “volatility skew.” Studies such as ~~Implied Volatility~~ “Implied Volatility” by Stewart Mayhew, Financial Analysts Journal, July-August 1995, have found that implied volatilities based on near-the-money options do as well as sophisticated weighted implied volatilities in estimating expected volatility. In addition, the staff believes that because near-the-money options are generally more actively traded, they may provide a better basis for deriving implied volatility.

FN48 The staff believes a company could use a weighted-average implied volatility based on traded options that are either in-the-money or out-of-the-money. For example, if the employee share option has an exercise price of \$52, but the only traded options available have exercise prices of \$50 and \$55, then the staff believes that it is appropriate to use a weighted average based on the implied volatilities from the two traded options; for this example, a 40% weight on the implied volatility calculated from the option with an exercise price of \$55 and a 60% weight on the option with an exercise price of \$50.

#### 4. Similarity of Length of Terms

The staff believes that when valuing an employee share option with a given expected or contractual term, as applicable, the implied volatility derived from a traded option with a similar term would be the most relevant. However, if there are no traded options with maturities that are similar to the share options contractual or expected term, as applicable, then the staff believes Company B could consider traded options with a remaining maturity of six months or greater. FN49 However, when using traded options with a term of less than one year, FN50 the staff would expect the company to also consider other relevant information in estimating expected volatility. In general, the staff believes more reliance on the implied volatility derived from a traded option would be expected the closer the remaining term of the traded option is to the expected or contractual term, as applicable, of the employee share option.

FN49 The staff believes it may also be appropriate to consider the entire term structure of volatility provided by traded options with a variety of remaining maturities. If a company considers the entire term structure in deriving implied volatility, the staff would expect a company to include some options in the term structure with a remaining maturity of six months or greater.

FN50 The staff believes the implied volatility derived from a traded option with a term of one year or greater would typically not be significantly different from the implied volatility that would be derived from a traded option with a significantly longer term.

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

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

Interpretive Response: As stated above, ~~Statement 123R [Topic 718]~~FASB ASC Topic 718 does not specify a method of estimating expected volatility; rather, it provides a list of factors that should be considered and requires that an entity's estimate of expected volatility be reasonable and supportable. FN51 Many of the factors listed in ~~Statement 123R [Topic 718]~~FASB ASC Topic 718 are discussed in Questions 2 and 3 above. The objective of estimating volatility, as stated in ~~Statement 123R [Topic 718]~~FASB ASC Topic 718, is to ascertain the assumption about expected volatility that marketplace participants would likely use in determining a price for an option. FN52 The staff believes that a company, after considering the factors listed in ~~Statement 123R [Topic 718]~~FASB ASC Topic 718, could, in certain situations, reasonably conclude that exclusive reliance on either historical or implied volatility would provide an estimate of expected volatility that meets this stated objective.

~~FN51 Statement 123R, paragraphs A31-A32 [paragraphs 718-10-55-36 through 55-37]~~FASB ASC paragraphs 718-10-55-36 through 718-10-55-37.

~~FN52 Statement 123R, paragraph B86 [paragraph 718-10-55-35]~~FASB ASC paragraph 718-10-55-35.

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

Company B utilizes a valuation model that is based upon a constant volatility assumption to value its employee share options; FN53

~~FN53 Statement 123R, paragraphs A15 and A33 [paragraphs 718-10-55-18 and 718-10-55-39], FASB ASC paragraphs 718-10-55-18 and 718-10-55-39~~ discuss the incorporation of a range of expected volatilities into option pricing models. The staff believes that a company that utilizes an option pricing model that incorporates a range of expected volatilities over the options contractual term should consider the factors listed in ~~Statement 123R [Topic 718]~~ FASB ASC Topic 718, and those discussed in the Interpretive Responses to Questions 2 and 3 above, to determine the extent of its reliance (including exclusive reliance) on the derived implied volatility.

The implied volatility is derived from options that are actively traded;

The market prices (trades or quotes) of both the traded options and underlying shares are measured at a similar point in time to each other and on a date reasonably close to the grant date of the employee share options;

The traded options have exercise prices that are both (a) near-the-money and (b) close to the exercise price of the employee share options; FN54 and

FN54 When near-the-money options are not available, the staff believes the use of a weighted-average approach, as noted in a previous footnote, may be appropriate.

The remaining maturities of the traded options on which the estimate is based are at least one year.

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

Company B has no reason to believe that its future volatility over the expected or contractual term, as applicable, is likely to differ from its past; FN55

~~FN55 See Statement 123R, paragraph B87 [paragraph 718-10-55-38]FASB ASC paragraph 718-10-55-38.~~ A change in a company's business model that results in a material alteration to the company's risk profile is an example of a circumstance in which the company's future volatility would be expected to differ from its past volatility. Other examples may include, but are not limited to, the introduction of a new product that is central to a company's business model or the receipt of U.S. Food and Drug Administration approval for the sale of a new prescription drug.

The computation of historical volatility uses a simple average calculation method;

A sequential period of historical data at least equal to the expected or contractual term of the share option, as applicable, is used; and

A reasonably sufficient number of price observations are used, measured at a consistent point throughout the applicable historical period. FN56

FN56 If the expected or contractual term, as applicable, of the employee share option is less than three years, the staff believes monthly price observations would not provide a sufficient amount of data.

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

Interpretive Response: ~~Statement 123R, paragraph A240 [paragraphs 718-10-50-2 through 50-3],FASB ASC paragraph 718-10-50-2~~ prescribes the minimum information needed to achieve the ~~Topic's~~Statement's disclosure objectives. FN57 Under that guidance, Company B is required to disclose the expected volatility and the method used to estimate it. FN58 Accordingly, the staff expects that at a minimum Company B would disclose in a footnote to its financial statements how it determined the expected volatility assumption for purposes of determining the fair value of its share options in accordance with ~~Statement 123R [Topic 718]FASB ASC Topic 718~~. For example, at a minimum, the staff would expect Company B to disclose whether it used only implied volatility, historical volatility, or a combination of both.

~~FN57 Statement 123R [Topic 718] disclosure requirements are included in paragraphs 64, 65, A240, A241, and A242 [Section 718-10-50]FASB ASC Section 718-10-50.~~

~~FN58 Statement 123R, paragraph A240(e)(2)(b) [paragraph 718-10-50-2(f)(2)(ii)]FASB ASC subparagraph 718-10-50-2(f)(2)(ii).~~

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

Facts: Company C is a newly public entity with limited historical data on the price of its publicly traded shares and no other traded financial instruments. Company C believes that it does not have sufficient company specific information regarding the volatility of its share price on which to base an estimate of expected volatility.

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

Interpretive Response: ~~Statement 123R [Topic 718]~~FASB ASC Topic 718 provides guidance on estimating expected volatility for newly public and nonpublic entities that do not have company specific historical or implied volatility information available. FN59 Company C may base its estimate of expected volatility on the historical, expected or implied volatility of similar entities whose share or option prices are publicly available. In making its determination as to similarity, Company C would likely consider the industry, stage of life cycle, size and financial leverage of such other entities. FN60

~~FN59 Statement 123R, paragraphs A22 and A43 [paragraphs 718-10-55-25 and 718-10-55-51]FASB ASC paragraphs 718-10-55-25 and 718-10-55-51.~~

~~FN60 Statement 123R, paragraph A22 [paragraph 718-10-55-25]FASB ASC paragraph 718-10-55-25.~~

The staff would not object to Company C looking to an industry sector index (e. g., NASDAQ Computer Index) that is representative of Company C's industry, and possibly its size, to identify one or more similar entities. FN61

Once Company C has identified similar entities, it would substitute a measure of the individual volatilities of the similar entities for the expected volatility of its share price as an assumption in its valuation model. FN62 Because of the effects of diversification that are present in an industry sector index, Company C should not substitute the volatility of an index for the expected volatility of its share price as an assumption in its valuation model. FN63

FN61 If a company operates in a number of different industries, it could look to several industry indices. However, when considering the volatilities of multiple companies, each operating only in a single industry, the staff believes a company should take into account its own leverage, the leverages of each of the entities, and the correlation of the entities stock returns.

FN62 ~~Statement 123R, paragraph A45 [paragraph 718-10-55-54]~~FASB ASC paragraph 718-10-55-51.

FN63 ~~Statement 123R, paragraph A22 [paragraph 718-10-55-54]~~FASB ASC paragraph 718-10-55-25.

After similar entities have been identified, Company C should continue to consider the volatilities of those entities unless circumstances change such that the identified entities are no longer similar to Company C. Until Company C has sufficient information available, the staff would not object to Company C basing its estimate of expected volatility on the volatility of similar entities for those periods for which it does not have sufficient information available. FN64 Until Company C has either a sufficient amount of historical information regarding the volatility of its share price or other traded financial instruments are available to derive an implied volatility to support an estimate of expected volatility, it should consistently apply a process as described above to estimate expected volatility based on the volatilities of similar entities. FN65

FN64 ~~Statement 123R, paragraph A32(c) [paragraph 718-10-55-37]~~FASB ASC paragraph 718-10-55-37. The staff believes that at least two years of daily or weekly historical data could provide a reasonable basis on which to base an estimate of expected volatility if a company has no reason to believe that its future volatility will differ materially during the expected or contractual term, as applicable, from the volatility calculated from this past information. If the expected or contractual term, as applicable, of a share option is shorter than two years, the staff believes a company should use daily or weekly historical data for at least the length of that applicable term.

~~FN65 Statement 123R, paragraph A34 [paragraph 718-10-55-40]FASB ASC paragraph 718-10-55-40.~~

## 2. Expected Term

~~Statement 123R, paragraph A26 [paragraph 718-10-55-29],FASB ASC paragraph 718-10-55-29~~ states, "The fair value of a traded (or transferable) share option is based on its contractual term because rarely is it economically advantageous to the holder to exercise, rather than sell, a transferable share option before the end of its contractual term. Employee share options generally differ from transferable [or tradable] share options in that employees cannot sell (or hedge) their share options – they can only exercise them; because of this, employees generally exercise their options before the end of the options contractual term. Thus, the inability to sell or hedge an employee share option effectively reduces the options value [compared to a transferable option] because exercise prior to the options expiration terminates its remaining life and thus its remaining time value." Accordingly, ~~Statement 123R [Topic 718]FASB ASC Topic 718~~ requires that when valuing an employee share option under the Black-Scholes-Merton framework the fair value of employee share options be based on the share options expected term rather than the contractual term.

The staff believes the estimate of expected term should be based on the facts and circumstances available in each particular case. Consistent with our guidance regarding reasonableness immediately preceding Topic 14.A, the fact that other possible estimates are later determined to have more accurately reflected the term does not necessarily mean that the particular choice was unreasonable. The staff reminds registrants of the expected term disclosure requirements described in ~~Statement 123R, paragraph A240(e)(2)(a) [paragraph 718-10-50-2(f)(2)(i)]FASB ASC subparagraph 718-10-50-2(f)(2)(i).~~

Facts: Company D utilizes the Black-Scholes-Merton closed-form model to value its share options for the purposes of determining the fair value of the options under ~~Statement 123R [Topic 718]FASB ASC Topic 718~~. Company D recently granted share options to its employees. Based on its review of various factors, Company D determines that the expected term of the options is six years, which is less than the contractual term of ten years.

Question 1: When determining the fair value of the share options in accordance with ~~Statement 123R [Topic 718]FASB ASC Topic 718~~, should Company D consider an additional discount for nonhedgability and nontransferability?

Interpretive Response: No. ~~Statement 123R, paragraphs A26 and B82 [paragraph 718-10-55-29]~~; FASB ASC paragraph 718-10-55-29 indicates that nonhedgability and nontransferability have the effect of increasing the likelihood that an employee share option will be exercised before the end of its contractual term. Nonhedgability and nontransferability therefore factor into the expected term assumption (in this case reducing the term assumption from ten years to six years), and the expected term reasonably adjusts for the effect of these factors. Accordingly, the staff believes that no additional reduction in the term assumption or other discount to the estimated fair value is appropriate for these particular factors. FN66

FN66 The staff notes the existence of academic literature that supports the assertion that the Black-Scholes-Merton closed-form model, with expected term as an input, can produce reasonable estimates of fair value. Such literature includes J. Carpenter, ~~The~~ "The exercise and valuation of executive stock options, options," Journal of Financial Economics, May 1998, pp.127-158; C. Marquardt, ~~The~~ "The Cost of Employee Stock Option Grants: An Empirical Analysis, Analysis," Journal of Accounting Research, September 2002, p. 1191-1217); and J. Bettis, J. Bizjak and M. Lemmon, ~~Exercise~~ "Exercise behavior, valuation, and the incentive effect of employee stock options, options," Journal of Financial Economics, forthcoming, 2005.

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

Interpretive Response: No. ~~Statement 123R [Topic 718]~~; FASB ASC Topic 718 indicates that the expected term that is utilized as an assumption in a closed-form option-pricing model or a resulting output of a lattice option pricing model when determining the fair value of the share options should not incorporate restrictions or other terms that stem from the pre-vesting forfeitability of the instruments. Under ~~Statement 123R [Topic 718]~~; FASB ASC Topic 718, these pre-vesting restrictions or other terms are taken into account by ultimately recognizing compensation cost only for awards for which employees render the requisite service. FN67.

FN67 ~~Statement 123R, paragraph 18 [paragraph 718-10-30-11]~~; FASB ASC paragraph 718-10-30-11.

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

Interpretive Response: No. The vesting period forms the lower bound of the estimate of expected term. FN68

~~FN68 Statement 123R, paragraph A28a [paragraph 718-10-55-31(a)]FASB ASC paragraph 718-10-55-31.~~

~~Question 4: Statement 123R, paragraph A30 [paragraph 718-10-55-34],FASB ASC paragraph 718-10-55-34~~ indicates that an entity shall aggregate individual awards into relatively homogenous groups with respect to exercise and post-vesting employment termination behaviors for the purpose of determining expected term, regardless of the valuation technique or model used to estimate the fair value. How many groupings are typically considered sufficient?

Interpretive Response: As it relates to employee groupings, the staff believes that an entity may generally make a reasonable fair value estimate with as few as one or two groupings. FN69

FN69 The staff believes the focus should be on groups of employees with significantly different expected exercise behavior. Academic research suggests two such groups might be executives and non-executives. A study by S. Huddart found executives and other senior managers to be significantly more patient in their exercise behavior than more junior employees. (Employee rank was proxied for by the number of options issued to that employee.) See S. Huddart, Patterns of stock option exercise in the United States, States, in: J. Carpenter and D. Yermack, eds., Executive Compensation and Shareholder Value: Theory and Evidence (Kluwer, Boston, MA, 1999), pp. 115-142. See also S. Huddart and M. Lang, Employee stock option exercises: An empirical analysis, analysis, Journal of Accounting and Economics, 1996, pp. 5-43.

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

Interpretive Response: A company should use an approach that is reasonable and supportable under ~~Statement 123R's [Topic 718]~~FASB ASC Topic 718's fair value measurement objective, which establishes that assumptions and measurement techniques should be consistent with those that marketplace participants would be likely to use in determining an exchange price for the share options. FN70 If, in developing its estimate of expected term, a company determines that its historical share option exercise experience is the best estimate of future exercise patterns, the staff will not object to the use of the historical share option exercise experience to estimate expected term. FN71

~~FN70 Statement 123R, paragraph A10 [paragraph 718-10-55-43]FASB ASC paragraph 718-10-55-13.~~

FN71 Historical share option exercise experience encompasses data related to share option exercise, post-vesting termination, and share option contractual term expiration.

A company may also conclude that its historical share option exercise experience does not provide a reasonable basis upon which to estimate expected term. This may be the case for a variety of reasons, including, but not limited to, the life of the company and its relative stage of development, past or expected structural changes in the business, differences in terms of past equity-based share option grants, FN72 or a lack of variety of price paths that the company may have experienced. FN73

FN72 For example, if a company had historically granted share options that were always in-the-money, and will grant at-the-money options prospectively, the exercise behavior related to the in-the-money options may not be sufficient as the sole basis to form the estimate of expected term for the at-the-money grants.

FN73 For example, if a company had a history of previous equity-based share option grants and exercises only in periods in which the company's share price was rising, the exercise behavior related to those options may not be sufficient as the sole basis to form the estimate of expected term for current option grants.

~~Statement 123R [Topic 718]~~FASB ASC Topic 718 describes other alternative sources of information that might be used in those cases when a company determines that its historical share option exercise experience does not provide a reasonable basis upon which to estimate expected term. For example, a lattice model (which by definition incorporates multiple price paths) can be used to estimate expected term as an input into a Black-Scholes-Merton closed-form model. FN74 In addition, ~~Statement 123R, paragraph A-29 [paragraph 718-10-55-32], states expected~~FASB ASC ~~paragraph 718-10-55-32 states "...expected~~ term might be estimated in some other manner, taking into account whatever relevant and supportable information is available, including industry averages and other pertinent evidence such as published academic ~~research, research.~~" For example, data about exercise patterns of employees in similar industries and/or situations as the company's might be used. While such comparative information may not be widely available at present, the staff understands that various parties, including actuaries, valuation professionals and others are gathering such data.

FN74 ~~Statement 123R, paragraph A-27 [paragraph 718-10-55-30]~~FASB ASC paragraph 718-10-55-30.

Facts: Company E grants equity share options to its employees that have the following basic characteristics: FN75.

FN75 Employee share options with these features are sometimes referred to as plain-vanilla options.

The share options are granted at-the-money;

Exercisability is conditional only on performing service through the vesting date; FN76

FN76 In this fact pattern the requisite service period equals the vesting period.

If an employee terminates service prior to vesting, the employee would forfeit the share options;

If an employee terminates service after vesting, the employee would have a limited time to exercise the share options (typically 30-90 days); and

The share options are nontransferable and nonhedgeable.

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

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

Interpretive Response: As noted above, the staff understands that an entity that is unable to rely on its historical exercise data may find that certain alternative information, such as exercise data relating to employees of other companies, is not easily obtainable. As such, some companies may encounter difficulties in making a refined estimate of expected term. Accordingly, if a company concludes that its historical share option exercise experience does not provide a reasonable basis upon which to estimate expected term, the staff will accept the following simplified method for plain vanilla options consistent with those in the fact set above:  $\text{expected term} = ((\text{vesting term} + \text{original contractual term}) / 2)$ . Assuming a ten year original contractual term and graded vesting over four years (25% of the options in each grant vest annually) for the share options in the fact set described above, the resultant expected term would be 6.25 years. FN77 Academic research on the exercise of options issued to executives provides some

general support for outcomes that would be produced by the application of this method. FN78

FN77 Calculated as  $\frac{[1 \text{ year vesting term (for the first 25\% vested)} + 2 \text{ year vesting term (for the second 25\% vested)} + 3 \text{ year vesting term (for the third 25\% vested)} + 4 \text{ year vesting term (for the last 25\% vested)}] \text{ divided by } 4 \text{ total years of vesting} + 10 \text{ year contractual life}}{2}$ ; that is,  $\frac{((1+2+3+4)/4) + 10}{2} = 6.25$  years.

~~Academic research on the exercise of options issued to executives provides some general support for outcomes that would be produced by the application of this method. FN78~~

FN78 J.N. Carpenter, ~~The~~ "The exercise and valuation of executive stock options, options," Journal of Financial Economics, 1998, pp.127-158 studies a sample of 40 NYSE and AMEX firms over the period 1979-1994 with share option terms reasonably consistent to the terms presented in the fact set and example. The mean time to exercise after grant was 5.83 years and the median was 6.08 years. The ~~mean~~ "mean time to exerciseexercise" is shorter than expected term since the study's sample included only exercised options. Other research on executive options includes (but is not limited to) J. Carr Bettis; John M. Bizjak; and Michael L. Lemmon, ~~Exercise~~ "Exercise behavior, valuation, and the incentive effects of employee stock options, options," forthcoming in the Journal of Financial Economics. One of the few studies on nonexecutive employee options the staff is aware of is S. Huddart, ~~Patterns~~ "Patterns of stock option exercise in the United States, States," in: J. Carpenter and D. Yermack, eds., Executive Compensation and Shareholder Value: Theory and Evidence (Kluwer, Boston, MA, 1999), pp. 115-142.

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

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

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

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

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

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

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

SAB Topic 14.E, ~~Statement 123R [Topic 718]~~ FASB ASC Topic 718, Compensation—Stock Compensation, and Certain Redeemable Financial Instruments

Certain financial instruments awarded in conjunction with share-based payment arrangements have redemption features that require settlement by cash or other assets upon the occurrence of events that are outside the control of the issuer. FN79 ~~Statement 123R [Topic 718]~~ FASB ASC Topic 718 provides guidance for determining whether instruments granted in conjunction with share-based payment arrangements should be classified as liability or equity instruments. Under that guidance, most instruments with redemption features that are outside the control of the issuer are required to be classified as liabilities; however, some redeemable instruments will qualify for equity classification. FN80 SEC Accounting Series Release No. 268, Presentation in Financial Statements of

~~Redeemable~~ “Redeemable Preferred Stocks, Stocks,” FN81 (ASR-268 “ASR 268”) and related guidance FN82 address the classification and measurement of certain redeemable equity instruments.

FN79 The terminology outside the control of the issuer is used to refer to any of the three redemption conditions described in Rule 5-02.28 of Regulation S-X that would require classification outside permanent equity. That rule requires preferred securities that are redeemable for cash or other assets to be classified outside of permanent equity if they are redeemable (1) at a fixed or determinable price on a fixed or determinable date, (2) at the option of the holder, or (3) upon the occurrence of an event that is not solely within the control of the issuer.

~~FN80 Statement 123R, paragraphs 28-35 and A225-A232 [paragraphs 718-10-25-6 through 25-19] FASB ASC paragraphs 718-10-25-6 through 718-10-25-19.~~

FN81 ASR 268, July 27, 1979, Rule 5-02.28 of Regulation S-X.

~~FN82 Related guidance includes EITF Abstracts Topic No. D-98, Classification and Measurement of Redeemable Securities (Topic D-98) [Section 480-10-S99] FASB ASC paragraph 480-10-S99-3A (Distinguishing Liabilities from Equity Topic).~~

Facts: Under a share-based payment arrangement, Company F grants to an employee shares (or share options) that all vest at the end of four years (cliff vest). The shares (or shares underlying the share options) are redeemable for cash at fair value at the ~~holders~~holder’s option, but only after six months from the date of share issuance (as defined in ~~Statement 123R~~FASB ASC Topic 718). Company F has determined that the shares (or share options) would be classified as equity instruments under the guidance of ~~Statement 123R [Topic 718]~~FASB ASC Topic 718. However, under ASR 268 and related guidance, the instruments would be considered to be redeemable for cash or other assets upon the occurrence of events (e. g., redemption at the option of the holder) that are outside the control of the issuer.

Question 1: While the instruments are subject to ~~Statement 123R [Topic 718]~~FASB ASC Topic 718, FN83 is ASR 268 and related guidance applicable to instruments issued under share-based payment arrangements that are classified as equity instruments under ~~Statement 123R [Topic 718]~~FASB ASC Topic 718?

~~FN83 Statement 123R, paragraph A231 [paragraph 718-10-35-43], FASB ASC paragraph 718-10-35-13 states that an instrument ceases to be subject to Statement 123R [this Topic] when the “the rights conveyed by the instrument to the holder are no longer dependent on the holder being an employee of the entity (that is, no longer dependent on providing service)-service).”~~

Interpretive Response: Yes. The staff believes that registrants must evaluate whether the terms of instruments granted in conjunction with share-based payment arrangements with employees that are not classified as liabilities under ~~Statement 123R [Topic 718]~~ FASB ASC Topic 718 result in the need to present certain amounts outside of permanent equity (also referred to as being presented in ~~temporary equity~~) “temporary equity”) in accordance with ASR 268 and related guidance. FN84

~~FN84 Instruments granted in conjunction with share-based payment arrangements with employees that do not by their terms require redemption for cash or other assets (at a fixed or determinable price on a fixed or determinable date, at the option of the holder, or upon the occurrence of an event that is not solely within the control of the issuer) would not be assumed by the staff to require net cash settlement for purposes of applying ASR 268 in circumstances in which paragraphs 14-18 of EITF Issue 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock [Section 815-40-25] FASB ASC Section 815-40-25, Derivatives and Hedging—Contracts in Entity's Own Equity—Recognition, would otherwise require the assumption of net cash settlement. See ~~Statement 123R, footnote 152 to paragraph B121 [Section 815-40-25]~~ FASB ASC paragraph 815-40-25-11, which states, in part: Issue 00-19 specifies that “...the events or actions necessary to deliver registered shares are not controlled by a company an entity and, therefore, except under limited the circumstances described in FASB ASC paragraph 815-40-25-16, such provisions would require a company to assume that the contract would be net cash settled if the contract permits the entity to net share or physically settle the contract only by delivering registered shares, it is assumed that the entity will be required to net cash settle the contract.” Thus, employee share options might be classified as substantive liabilities if they were subject to Issue 00-19 [Section 815-40-25]; however, for purposes of this Statement, the Board does not believe that employee share options should be classified as liabilities based solely on that notion. See also Statement 123R, footnote 20 [paragraph 718-10-25-45(a)] FASB ASC subparagraph 718-10-25-15(a).~~

When an instrument ceases to be subject to ~~Statement 123R [Topic 718]~~FASB ASC Topic 718 and becomes subject to the recognition and measurement requirements of other applicable GAAP, the staff believes that the company should reassess the classification of the instrument as a liability or equity at that time and consequently may need to reconsider the applicability of ASR 268.

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

Interpretive Response: Under ~~Statement 123R [Topic 718]~~FASB ASC Topic 718, when compensation cost is recognized for instruments classified as equity instruments, additional paid-in-capital FN85 is increased. If the award is not fully vested at the grant date, compensation cost is recognized and additional paid-in-capital is increased over time as services are rendered over the requisite service period. A similar pattern of recognition should be used to reflect the amount presented as temporary equity for share-based payment awards that have redemption features that are outside the issuers control but are classified as equity instruments under ~~Statement 123R [Topic 718]~~FASB ASC Topic 718. The staff believes Company F should present as temporary equity at each balance sheet date an amount that is based on the redemption amount of the instrument, but takes into account the proportion of consideration received in the form of employee services. Thus, for example, if a nonvested share that qualifies for equity classification under ~~Statement 123R [Topic 718]~~FASB ASC Topic 718 is redeemable at fair value more than six months after vesting, and that nonvested share is 75% vested at the balance sheet date, an amount equal to 75% of the fair value of the share should be presented as temporary equity at that date. Similarly, if an option on a share of redeemable stock that qualifies for equity classification under ~~Statement 123R [Topic 718]~~FASB ASC Topic 718 is 75% vested at the balance sheet date, an amount equal to 75% of the intrinsic FN86 value of the option should be presented as temporary equity at that date.

FN85 Depending on the fact pattern, this may be recorded as common stock and additional paid in capital.

FN86 The potential redemption amount of the share option in this illustration is its intrinsic value because the holder would pay the exercise price upon exercise of the option and then, upon redemption of the underlying shares, the company would pay the holder the fair value of those shares. Thus, the net cash outflow from the arrangement would be equal to the intrinsic value of the share option. In situations where there would be no cash inflows from the share

option holder, the cash required to be paid to redeem the underlying shares upon the exercise of the put option would be the redemption value.

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

Interpretive Response: See Topic 14.A for a discussion of the application of the principles in ~~Statement 123R [Topic 718]~~FASB ASC Topic 718 to nonemployee awards. The staff believes it would generally be appropriate to apply the methodology described in the Interpretive Response to Question 2 above to nonemployee awards.

#### **SAB Topic 14.F, Classification of Compensation Expense Associated with Share-based Payment Arrangements**

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

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

Interpretive Response: The staff believes Company G should present the expense related to share-based payment arrangements in the same line or lines as cash compensation paid to the same employees. FN87 The staff believes a company could consider disclosing the amount of expense related to share-based payment arrangements included in specific line items in the financial statements. Disclosure of this information might be appropriate in a parenthetical note to the appropriate income statement line items, on the cash flow statement, in the footnotes to the financial statements, or within MD&A.

FN87 ~~Statement 123R [Topic 718]~~FASB ASC 718 does not identify a specific line item in the income statement for presentation of the expense related to share-based payment arrangements.

~~(SAB Topics 14.G–14.H Removed by SAB 114) SAB Topic 14.G, Non-GAAP Measures~~

Facts: Company H, a calendar year company, adopts Statement 123R as of July 1, 2005. Company H has issued share options to its employees each year since issuing publicly traded stock twenty years ago. In the MD&A section of its 2005 Form 10-K, Company H believes it would be useful to investors to disclose what net income would be before considering the effect of accounting for share-based payment transactions in accordance with Statement 123R [Topic 718].

Question 1: Does the resulting measure, Net Income Before Share Based Payment Charge, or an equivalent measure, meet the definition of a non-GAAP measure in Regulation G and Item 10(e) of Regulation S-K? FN88

FN88 17 CFR 229.10(e). All references to Item 10(e) of Regulation S-K also includes corresponding provisions of Item 10(h) of Regulation S-B with respect to small business issuers as well as US GAAP information of foreign private issuers under General Instruction C(e) of Form 20-F.

Interpretive Response: Yes. Because the financial measure Company H is considering excludes an amount (share-based payment expense) that is included in the most directly comparable measure calculated and presented in accordance with GAAP (net income), it would be considered a non-GAAP financial measure pursuant to the provisions of Regulation G and Item 10(e) of Regulation S-K.

Question 2: Is the measure Net Income Before Share Based Payment Charge, or an equivalent measure, a prohibited non-GAAP measure pursuant to Item 10(e) of Regulation S-K?

Interpretive Response: Item 10(e) prohibits the inclusion of certain non-GAAP financial measures and also mandates specific disclosures for registrants that include permitted non-GAAP financial measures in filings. Generally, under Item 10(e) of Regulation S-K, a company may not present a non-GAAP performance measure that removes an expense from net income by identifying that expense as non-recurring, infrequent, or unusual if it is reasonably likely that the expense will recur within two years or if the company had a similar expense within the prior two years. The staff issued Frequently Asked Questions Regarding the Use of Non-GAAP Measures in June of 2003. Question 8 discusses whether it is appropriate to eliminate or smooth an item that is identified as recurring. The staff answered the question in part by stating Companies should never use a non-GAAP financial measure in an attempt to smooth earnings. Further, while there is no per se prohibition against removing a recurring item, companies must meet the burden of demonstrating the usefulness of any measure that

~~excludes recurring items, especially if the non-GAAP financial measure is used to evaluate performance.~~

~~The staff believes that a measure used by the management of Company H that excludes share-based payments internally to evaluate performance may be relevant disclosure for investors. In these cases, if Company H determines that the non-GAAP financial measure Net Income Before Share-Based Payment Charge does not violate any of the prohibitions from inclusion in filings with the Commission outlined in Item 10(e) of Regulation S-K, Company H's management would be required to disclose, among other items, the following:~~

~~The reasons that the company's management believes that presentation of the non-GAAP financial measure provides useful information to investors regarding the company's financial condition and results of operations; and.~~

~~To the extent material, the additional purposes, if any, for which the company's management uses the non-GAAP financial measure that are not otherwise disclosed. FN89~~

~~FN89 17 CFR 229.10(e)(1).~~

~~In addition, the staff's response to Question 8 included in Frequently Asked Questions Regarding the Use of Non-GAAP Measures in June of 2003 notes that the inclusion of a non-GAAP financial measure may be misleading absent the following disclosures:~~

~~The manner in which management uses the non-GAAP measure to conduct or evaluate its business;~~

~~The economic substance behind management's decision to use such a measure;~~

~~The material limitations associated with use of the non-GAAP financial measure as compared to the use of the most directly comparable GAAP financial measure;~~

~~The manner in which management compensates for these limitations when using the non-GAAP financial measure; and~~

~~The substantive reasons why management believes the non-GAAP financial measure provides useful information to investors.~~

~~Question 3: How could Company H demonstrate the effect of accounting for share based payment transactions in accordance with Statement 123R [Topic 718] and Regulation G and Item 10(e) of Regulation S-K in its Form 10-K?~~

~~Interpretive Response: The staff believes that including a discussion in MD&A addressing significant trends and variability of a company's earnings and changes in the significant components of certain line items is important to assist an investor in understanding the company's performance. The staff also understands that expenses from share-based payments might vary in different ways and for different reasons than would other expenses. In particular, the staff believes Company H's investors would be well served by disclosure in MD&A that explains the components of the company's expenses, including, if material, identification of the amount of expense associated with share-based payment transactions and discussion of the reasons why such amounts have fluctuated from period to period.~~

~~Question 4: Would the staff object to Company H including a pro-forma income statement in its SEC filings that removes from net income the effects of accounting for share based payment arrangements in accordance with Statement 123R [Topic 718]?~~

~~Interpretive Response: Yes. Removal of the effects of accounting for share-based payment arrangements in accordance with Statement 123R [Topic 718] would not meet any of the conditions in Rule 11-01(a) of Regulation S-X for presentation of pro forma financial information. Further, the removal of the effects of accounting for share-based payment arrangements in accordance with Statement 123R [Topic 718] would not meet any of the conditions in Rule 11-02(b)(6) of Regulation S-X to be reflected as a pro forma adjustment in circumstances where pro forma financial information is required under Rule 11-01(a) of Regulation S-X for other transactions such as recent or probable business combinations.~~

~~In addition, Item 10(e) of Regulation S-X prohibits presenting non-GAAP financial measures on the face of any pro forma financial information required to be disclosed by Article 11 of Regulation S-X. Further, a company may not present non-GAAP financial measures on the face of the company's financial statements prepared in accordance with GAAP or in the accompanying notes.~~

~~SAB Topic 14.H, First Time Adoption of Statement 123R in an Interim Period~~

~~Facts: Company I's fiscal year begins on January 1, 2005. Company I plans to adopt Statement 123R on July 1, 2005, which is the beginning of its first~~

interim period following the effective date. Company I previously recognized share based payment compensation in accordance with Opinion 25.

~~Question 1: What disclosures are required in Company I's Form 10-Q for the third quarter of 2005?~~

~~Interpretive Response: The disclosures required by paragraphs 64-65, 84, and A240-242 of Statement 123R should be included in the Form 10-Q for the interim period when Statement 123R is first adopted. If Company I applies the modified retrospective method FN90 in other than the first interim period of a fiscal year, the staff believes that the Form 10-Q for the period of adoption should include disclosure of the effects of the adoption of Statement 123R on previously reported interim periods. FN91 If Company I applies the modified prospective method, FN92 the financial statements for Company I's prior interim periods and fiscal years will not reflect any restated amounts. The staff believes that Company I should disclose this fact. Regardless of the transition method chosen, Company I should also provide the disclosures required by SAB Topic 11M, Disclosure Of The Impact That Recently Issued Accounting Standards Will Have On The Financial Statements Of The Registrant When Adopted In A Future Period, in interim and annual financial statements preceding the adoption of Statement 123R.~~

~~FN90 Statement 123R, paragraph 76.~~

~~FN91 See Statement 123R, paragraph 77.~~

~~FN92 Statement 123R, paragraph 74.~~

~~Facts: Company J plans to adopt Statement 123R by applying the modified retrospective method only to the preceding interim periods of its current fiscal year. Company J anticipates recording an adjustment upon the adoption of Statement 123R to reflect the cumulative effect of reclassifying certain share based payment arrangements as liabilities.~~

~~Question 2: Would Company J be required to apply the cumulative effect adjustment to the beginning of the fiscal year and to reflect the change in classification from liabilities to equity to its interim periods preceding adoption in accordance with Statement 3, FN93 paragraph 10?~~

~~FN93 Statement of Financial Accounting Standards No. 3, Reporting Accounting Changes in Interim Financial Statements (Statement 3).~~

~~Interpretive Response: No. Statement 123R, paragraph 76, limits retrospective application to recording compensation cost for unvested awards based on the amounts previously determined under Statement 123 for pro forma footnote disclosure. Any adjustments to be recorded as a cumulative effect of a change in accounting principle should be recorded as of the date of adoption of Statement 123R, which may occur after the beginning of the fiscal year. Therefore, based on the guidance in Statement 123R, paragraphs 79-82, registrants are not required to apply the provisions of Statement 3, paragraph 10.~~

#### SAB Topic 14.I, Capitalization of Compensation Cost Associated with Share-Based Arrangements

Facts: Company K is a manufacturing company that grants share options to its production employees. Company K has determined that the cost of the production employees service is an inventoriable cost. As such, Company K is required to initially capitalize the cost of the share option grants to these production employees as inventory and later recognize the cost in the income statement when the inventory is consumed. FN94

~~FN94 Statement 123R, paragraph 5 [paragraph 718-10-25-2]FASB ASC paragraph 718-10-25-2.~~

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

~~Interpretive Response: No. Statement 123R [Topic 718]FASB ASC Topic 718, Compensation—Stock Compensation, does not prescribe the mechanism a company should use to incorporate a portion of share-option costs in an inventory-costing system. The staff believes Company K may accomplish this through a period end adjustment to its financial statements. Company K should establish appropriate controls surrounding the calculation and recording of this period end adjustment, as it would any other period end adjustment. The fact that the entry is recorded as a period end adjustment, by itself, should not impact managements ability to determine that the internal control over financial reporting, as defined by the SEC's rules implementing Section 404 of the Sarbanes-Oxley Act of 2002, FN95 is effective.~~

FN95 Release No. 34-47986, June 5, 2003, Managements Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Period Reports.

~~(SAB Topics 14.J–14.M Removed by SAB 114)SAB Topic 14.J, Accounting for Income Tax Effects of Share-based Payment Arrangements upon Adoption of Statement 123R~~

~~Facts: In accordance with Statement 123R [Subtopic 718-740], reporting entities will need to determine whether deductions reported on tax returns for share-based payment awards exceed or are less than the cumulative compensation cost recognized for financial reporting. If the deductions exceed the cumulative compensation cost recognized for financial reporting, the entity generally should record any resulting excess tax benefits as additional paid in capital. If deductions are less than the cumulative compensation cost recognized for financial reporting, the entity should record the write-off of the deferred tax asset, net of the related valuation allowance, against any remaining additional paid in capital from previous awards accounted for in accordance with the fair value method of Statement 123 or Statement 123R [Subtopic 718-740], as applicable. The remaining balance, if any, of the write-off of the deferred tax asset shall be recognized in the income statement. FN96~~

~~FN96 Statement 123R, paragraph 63 [paragraph 718-740-45-4].~~

~~Company L is an entity that previously recognized employee share-based payment costs under the intrinsic value method of Opinion 25. In this situation, Statement 123R [Subtopic 718-740] states that Company L shall calculate the amount available for offset [in additional paid in capital] as the net amount of excess tax benefits that would have qualified as such had it instead adopted Statement 123 for recognition purposes pursuant to Statement 123's original effective date and transition method. FN97~~

~~FN97 Ibid.~~

~~Question: When is Company L required to calculate the additional paid in capital from previous share-based payment awards that is available for offset against the write-off of a deferred tax asset?~~

~~Interpretive Response: Statement 123R [Subtopic 718-740] will necessitate the tracking of tax attributes relating to share-based payment transactions with employees for a number of reasons, including the requirements related to any required write-off of excess deferred tax assets upon settlement of a share option. While it is important that appropriate detailed information be available when needed for consideration, the timing as to when such information actually affects financial reporting will vary from company to company. In preparation for the adoption of Statement 123R [Subtopic 718-740], Company L should evaluate the level of detail which may be required considering its particular facts and circumstances.~~

~~Statement 123R [Subtopic 718-740] is silent as to when the additional paid-in capital available for offset should be calculated. However, the staff notes that Company L would not be required to calculate the additional paid-in capital available for offset by the date it adopts Statement 123R. In addition, the staff notes that Statement 123R [Subtopic 718-740] does not require disclosure of the additional paid-in capital available for offset. FN98 The staff believes that Company L need only calculate the additional paid-in capital available for offset if and when Company L faces a situation in which deductions reported on its tax return are less than the relevant deferred tax asset. In addition, Company L need only perform the calculations periodically to the extent necessary to conclude that sufficient paid-in capital is available for the offset of the deduction shortfall.~~

~~FN98 Statement 123R's disclosure requirements are described in paragraphs 64, 65, A240, A241 and A242 [Section 718-10-50].~~

~~SAB Topic 14.K, Modification of Employee Share Options Prior to Adoption of Statement 123R~~

~~Facts: Company M is a public entity that historically applied the recognition provisions of Opinion 25 and intends to transition to Statement 123R under the modified prospective method of application. FN99 In prior periods, Company M granted at the money share options to its employees in which the exercisability of the options is conditional only on performing service through the vesting date. FN100 Since the time of grant, Company M's share price has fallen such that the share options are out-of-the-money. Prior to adoption of Statement 123R the share options are still unvested, and Company M intends to modify these unvested share options to accelerate the vesting. Company M has determined that the modification to accelerate vesting will not require recognition of compensation cost in its financial statements in the period of the modification under the provisions of Opinion 25. FN101 However, Company M intends to reflect the compensation cost related to the modification in its fair value pro forma disclosures under Statement 123, FN102 in the period the modification is made.~~

~~FN99 Statement 123R, paragraph 74.~~

~~FN100 The terms of these share options do not define the service period as being other than the vesting period.~~

~~FN101 See FASB Interpretation No. 44, Accounting for Certain Transactions Involving Stock Compensation, paragraph 36, which requires the recognition of compensation expense under Opinion 25 due to a modification of a share-based payment award only if, absent~~

~~the acceleration of vesting, the award would have otherwise been forfeited during the vesting period pursuant to its original terms.~~

~~FN102 Statement 123, paragraph 45, as amended by Statement 148, Accounting for Stock-Based Compensation Transition and Disclosure (Statement 148).~~

~~Question: Would the staff object to Company M reflecting the remaining compensation cost related to these share options in the fair value pro forma disclosures required under Statement 123 as a result of the modification in the period in which the modification was enacted?~~

~~Interpretive Response: No. The staff believes that an acceptable interpretation of Statement 123 is that the modification to accelerate the vesting of such share options would result in the recognition of the remaining amount of compensation cost in the period the modification is made, so long as the acceleration of vesting permits employees to exercise the share options in a circumstance when they would not otherwise have been able to do so absent the modification. The staff notes that the service period definition in Statement 123 FN103 indicates, if the service period is not defined as an earlier or shorter period, it shall be presumed to be the vesting period. After the modification, Company M's share options will be vested pursuant to the awards terms. Accordingly, under this interpretation, there is no remaining service period and any remaining unrecognized service cost for those share options should be recognized at the date of the modification. The staff believes that since the remaining unrecognized compensation cost is accelerated and recognized at the date of modification, no compensation cost would be recognized for these modified share options in the income statement in the periods after adoption of Statement 123R, absent any further modifications.~~

~~FN103 Statement 123, Appendix E.~~

~~The staff reminds public entities that Statement 123, paragraph 47, indicates that for each year an income statement is provided, the terms of significant modifications of outstanding awards shall be disclosed. In order to inform investors about modification transactions and managements reasons for entering into those transactions, the staff believes that public entities should specifically disclose any modifications to accelerate the vesting of out of the money share options in anticipation of adopting Statement 123R, including the reasons for modifying the option terms.~~

~~SAB Topic 14.L, Application of the Measurement Provisions of Statement 123R [Topic 718] to Foreign Private Issuers FN104~~

FN104 As defined in Regulation C230.405

~~Question: Does the staff believe there are differences in the measurement provisions for share-based payment arrangements with employees under International Accounting Standards Board International Financial Reporting Standard 2, Share-based Payment (IFRS 2) and Statement 123R [Topic 718] that would result in a reconciling item under Item 17 or 18 of Form 20-F?~~

~~Interpretive Response: The staff believes that application of the guidance provided by IFRS 2 regarding the measurement of employee share options would generally result in a fair value measurement that is consistent with the fair value objective stated in Statement 123R [Topic 718]. FN105 Accordingly, the staff believes that application of Statement 123R's [Topic 718] measurement guidance would not generally result in a reconciling item required to be reported under Item 17 or 18 of Form 20-F for a foreign private issuer that has complied with the provisions of IFRS 2 for share-based payment transactions with employees. However, the staff reminds foreign private issuers that there are certain differences between the guidance in IFRS 2 and Statement 123R [Topic 718] that may result in reconciling items. FN106.~~

~~FN105 Statement 123R, paragraph A2 [paragraph 718-10-55-4].~~

~~FN106 Statement 123R, paragraphs B258-B269, identify the more significant differences between IFRS 2 and Statement 123R.~~

~~SAB Topic 14.M, Disclosures in MD&A Subsequent to Adoption of Statement 123R~~

~~Question: What disclosures should companies consider including in MD&A to highlight the effects of 1) differences between the accounting for share-based payment arrangements before and after the adoption of Statement 123R and 2) changes to share-based payment arrangements?~~

~~Interpretive Response: As stated in SEC Release FR-72, the principal objectives of MD&A are to give readers a view of a company through the eyes of management, to provide the context within which financial information should be analyzed and to provide information about the quality of, and potential variability of, a company's earnings and cash flow, so that investors can ascertain the likelihood that past performance is indicative of future performance. The adoption of Statement 123R may result in significant differences between the financial statements of periods before and after the adoption, especially for companies with significant share-~~

~~based compensation programs that have followed the recognition provisions of Opinion 25 or that adopted the fair value based method for financial statement recognition in accordance with Statement 123 using the prospective method permitted by Statement 148. Furthermore, the staff understands that companies may refine their estimates of assumptions as a result of implementing Statement 123R and the interpretive guidance provided in this SAB. In addition, the staff understands that many companies are evaluating their share based payment arrangements and making changes to those arrangements.~~

~~Each of these situations may affect the comparability of financial statements. Accordingly, to assist investors and other users of financial statements in understanding the financial results of a company that has adopted Statement 123R, the staff believes that companies should consider including in MD&A material qualitative and quantitative information about any of the following, as well as other information that could affect comparability of financial statements from period to period:~~

~~Transition method selected (e. g., modified prospective application or modified retrospective application) and the resulting financial statement impact in current and future reporting periods;~~

~~Method utilized by the company to account for share based payment arrangements in periods prior to the adoption of Statement 123R and the impact, or lack thereof, on the prior period financial statements;~~

~~Modifications made to outstanding share options prior to the adoption of Statement 123R and the reason(s) for the modification;~~

~~Differences in valuation methodologies or assumptions compared to those that were used in estimating the fair value of share options under Statement 123;~~

~~Changes in the quantity or type of instruments used in share based payment programs, such as a shift from share options to restricted shares;~~

~~Changes in the terms of share based payment arrangements, such as the addition of performance conditions;~~

~~A discussion of the one-time effect, if any, of the adoption of Statement 123R, such as any cumulative adjustments recorded in the financial statements; and~~

~~Total compensation cost related to nonvested awards not yet recognized and the weighted average period over which it is expected to be recognized.~~

23. Amend paragraph 730-20-S99-1, with no link to a transition paragraph, as follows:

**Research and Development—Research and Development Arrangements**

**SEC Materials**

**> SEC Staff Guidance**

**> > Staff Accounting Bulletins**

**> > > SAB Topic 5.O, Research and Development Arrangements**

**730-20-S99-1** The following is the text of SAB Topic 5.O, Research and Development Arrangements.

Facts: ~~FASB ASC paragraph 730-20-25-5 (Research and Development Topic) Statement 68 paragraph 7 [paragraph 730-20-25-5]~~ 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) Paragraph 8(c) [paragraph 730-20-25-6]~~ 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) paragraph 8(c) of Statement 68 [paragraph 730-20-25-6]~~?

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. FN14 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.

FN14 Related parties as used herein are as defined in ~~the FASB ASC Master Glossary paragraph 24 of Statement 57 [the FASB Codification Glossary: **Related Parties**]~~.

Question 2: ~~FASB ASC paragraph 730-20-25-5 Paragraph 7 of Statement 68 [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~~ ~~Paragraph 5 of Statement 68 [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.

24. Amend paragraph 805-10-S99-2, with no link to a transition paragraph, as follows:

## **Business Combinations—Overall**

### **SEC Materials**

#### **> SEC Staff Guidance**

#### **> > Staff Accounting Bulletins**

#### **> > > SAB Topic 2.A.8, Business Combinations Prior to a Initial Public Offering**

**805-10-S99-2** The following is the text of SAB Topic 2.A.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, Statement 141(R)~~. Accordingly, the staff believes that the combination of two or more businesses should be accounted for in accordance with ~~FASB ASC Topic 805, Statement 141(R) (Topic 805)~~.

25. Amend paragraph 805-50-S99-1, with no link to a transition paragraph, as follows:

## **Business Combinations—Related Issues**

### **SEC Materials**

#### **> SEC Staff Guidance**

#### **>> Staff Accounting Bulletins**

#### **>>> SAB Topic 5.J, New Basis of Accounting Required in Certain Circumstances**

**805-50-S99-1** The following is the text of SAB Topic 5.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 non-controlling 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. FN6 Should Company B's new basis ("push down") financial statements include Company A's debt related to its purchase of Company B?

FN6 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.

Interpretive Response: The staff believes that Company A's debt, FN7 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.

FN7 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.

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. FN8 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, Statements 5 (Topic 450), and 57 (Topic 850) as well as Interpretation 45 require sufficient disclosure to allow users of Company B's financial statements to fully understand the impact of the relationship on Company B's present and future cash flows. Rule 4-08(e) of Regulation S-X also requires disclosure of restrictions which limit the payment of dividends. Therefore, the staff believes that the equity section of Company B's balance sheet and any pro forma financial information and capitalization tables should clearly disclose that this arrangement exists. FN9

FN8 The staff does not believe Company B's financial statements must reflect the debt in this situation because in the event of default on the debt by Company A, the debt holder(s) would only be entitled to B's stock held by Company A. Other equity or debt holders of Company B would retain their priority with respect to the net assets of Company B.

FN9 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.

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 FN10 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.

FN10 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."

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.

26. Amend paragraph 810-10-S99-5, with no link to a transition paragraph, as follows:

**Consolidation—Overall**

**SEC Materials**

**> SEC Staff Guidance**

**> > Staff Accounting Bulletins**

**> > > SAB Topic 5.E, Accounting for Divestiture of a Subsidiary or Other Business Operations**

**810-10-S99-5** The following is the text of SAB Topic 5.E, Accounting for Divestiture of a Subsidiary or Other Business Operations.

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 divestiture 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; ~~FIN 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of the Indebtedness of Others* (Subtopic 460-10)~~; the contingent liability for performance on existing contracts in accordance with FASB ASC Topic 450, Contingencies; ~~Statement 5, *Accounting for Contingencies* (Subtopic 450-20)~~; and the promissory notes in accordance with FASB ASC Topic 310, Receivables, and FASB ASC Topic 835, Interest; ~~APB 21, *Interest on Receivables and Payables*~~, and ~~Statements 114, *Accounting by Creditors for Impairment of a Loan*~~, and ~~118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures* (Subtopic 310-10)~~.

27. Amend paragraph 815-10-S99-1, with no link to a transition paragraph, as follows:

## **Derivatives and Hedging—Overall**

### **SEC Materials**

#### **> SEC Staff Guidance**

#### **> > Staff Accounting Bulletins**

#### **> > > SAB Topic 5.DD, Written Loan Commitments Recorded at Fair Value through Earnings**

**815-10-S99-1** The following is the text of SAB Topic 5.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) 815-10-15-74, 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, Topic 815. However, FASB ASC subparagraph 825-10-15-4(c) (Financial Instruments Topic), paragraph 825-10-15-4(c), 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, Subtopic 825-10, 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, Topic 815, 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 FASB ASC Subtopic 860-50, Transfers and Servicing—Servicing Assets and Liabilities, FN60–FN4, 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, Topic 860. However, as discussed in FASB ASC paragraph 860-50-25-1, paragraphs 860-50-30-1 through 30-2, 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.

FN60~~FN4~~ 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.

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 ~~Topic 815~~ 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 ~~and 310-10-35-52 require~~ 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.

28. Amend paragraph 845-10-S99-1, with no link to a transition paragraph, as follows:

## **Nonmonetary Transactions—Overall**

### **SEC Materials**

#### **> SEC Staff Guidance**

#### **> > Staff Accounting Bulletins**

#### **> > > SAB Topic 5.G, Transfers of Nonmonetary Assets by Promoters or Shareholders**

**845-10-S99-1** The following is the text of SAB Topic 5.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 ~~paragraph 4 of APB Opinion 29 states that Opinion 29 [paragraph 845-10-15-4]~~ 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 ~~FN1FN3~~ 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.

~~FN1FN3~~ 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.

29. Amend paragraph 852-20-S99-2, with no link to a transition paragraph, as follows:

## **Reorganizations—Quasi-Reorganizations**

### **SEC Materials**

#### **> SEC Staff Guidance**

#### **> > Staff Accounting Bulletins**

#### **> > > SAB Topic 5.S, Quasi-Reorganization**

**852-20-S99-2** The following is the text of SAB Topic 5.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 ~~FN25FN21~~ 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.

~~FN25~~FN21 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.

Question 1: May the company reclassify its capital accounts to eliminate the accumulated deficit without satisfying all of the conditions enumerated in Section 210 ~~FN26~~FN22 of the Codification of Financial Reporting Policies for a quasi-reorganization?

~~FN26~~FN22 ASR 25.

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 ~~FN27~~FN23 for a quasi-reorganization are satisfied. ~~FN28~~FN24

~~FN27~~FN23 Section 210 (ASR 25) indicates the following conditions under which a quasi-reorganization can be effected without the creation of a new corporate entity and without the intervention of formal court proceedings: 1. Earned surplus, as of the date selected, is exhausted; 2. Upon consummation of the quasi-reorganization, no deficit exists in any surplus account; 3. The entire procedure is made known to all persons entitled to vote on matters of general corporate policy and the appropriate consents to the particular transactions are obtained in advance in accordance with the applicable laws and charter provisions; 4. The procedure accomplishes, with respect to the accounts, substantially what might be accomplished in a reorganization by legal proceedings - namely, the restatement of assets in terms of present considerations as well as appropriate modifications of capital and capital surplus, in order to obviate, so far as possible, the necessity of future reorganization of like nature.

~~FN28~~FN24 In addition, ~~ARB 43, Chapter 7A [Subtopic 852-20]~~FASB ASC Subtopic 852-20, Reorganizations—Quasi-Reorganizations, outlines procedures that must be followed in connection with and after a quasi-reorganization.

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. ~~FN29~~FN25

~~FN29~~FN25 ~~Opinion 20 [Topic 250]~~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.

~~Chapter 7A of ARB 43 [paragraph 852-20-25-5]~~FASB ASC paragraph 852-20-25-5 (Reorganizations Topic) indicates that, following a quasi-reorganization, ~~an~~ "company's ~~entity's~~ accounting ~~should~~shall be substantially similar to that appropriate for a new ~~company~~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. ~~FN30~~FN26 ~~Chapter 7A of ARB 43 [paragraph 852-20-30-2]~~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, ~~{add italics}~~ determined with due regard for the accounting to be subsequently employed by the ~~entity~~Company thereafter." ~~{add italics}~~ (emphasis added)

~~FN30~~FN26 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.

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. ~~FN34~~FN27

~~FN34~~FN27 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.

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. ~~FN32FN28~~ 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?

~~FN32FN28~~ See footnote ~~27~~23.

Interpretive Response: The staff believes ~~Statement 109~~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, ~~FN33FN29~~ 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. ~~FN34FN30~~

~~FN33FN29~~ 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, **{add italics}** but only under circumstances which would justify an actual reorganization or formation of a new corporation, **{add italics}** particularly if the sole purpose of the quasi-reorganization is the elimination of a deficit in earned surplus resulting from operating losses." (emphasis added)

~~FN34FN30 FASB Special Report: A Guide to Implementation of Statement 109 on Accounting for Income Taxes: Questions and Answers answer 9 [paragraph 852-740-55-4]ASC paragraph 852-740-55-4 states in part: "ARB 43, Chapter 7 [paragraph 852-20-25-5], 'Capital Accounts,' states thatAs indicated in paragraph 852-20-25-5, after a quasi-reorganization, the enterprise's accounting shouldshall be substantially similar to that appropriate for a new enterpriseentity. As such, any subsequently recognized tax benefit of an operating loss or tax credit carryforward that existed at the date of a quasi-reorganization shouldshall not be included in the determination of income of the "new" enterpriseentity, regardless of whether losses that gave rise to an operating loss carryforward were charged to income prior to the quasi-reorganization or directly to contributed capital as part of the quasi-reorganization. A new enterpriseentity would not have tax benefits attributable to operating losses or tax credits that arose prior to its organization date."~~

~~The FASB recognized that a practice existed of recording deficit elimination type quasi-reorganizations without evaluating the concurrent need to restate assets and liabilities to fair values, and provided guidance on accounting for the tax benefits of carryforward items subsequent to such an event. FN35 This practice and accounting is not permitted by Section 210, and accordingly, is not appropriate for registrants. The staff believes that all registrants that comply with the requirements of Section 210 in effecting a quasi-reorganization should apply the accounting required by the first sentence of paragraph 39 of Statement 109 [paragraph 852-740-45-3]FASB ASC paragraph 852-740-45-3 for the tax benefits of tax carryforward items. FN36FN31 FN32 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.~~

~~FN35 Statement 100, paragraph 39, states, in part: "The only exception is for enterprises that have previously both adopted Statement 96 and effected a quasi reorganization that involves only the elimination of a deficit in retained earnings by a concurrent reduction in contributed capital prior to adopting this Statement. For those enterprises, subsequent recognition of the tax benefit of prior deductible temporary differences and carryforwards is included in income and reported as required by paragraph 37... and then reclassified from retained earnings to contributed capital." Also, see Footnote 10."FN31 [Original footnote removed by SAB 114.]~~

~~FN36 The first sentence of paragraph 39 of Statement 100 [paragraph 852-740-45-3]FN32 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 ARB 43, Chapter 7 [Subtopic 852-20]FASB ASC Subtopic 852-20, ordinarily are reported as a direct addition to contributed capital if the tax benefits are recognized in subsequent years."~~

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

Interpretive Response: No. The staff believes ~~Opinion 20 [Topic 250]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 ~~which~~that is being terminated ***{add italics}***or ~~which~~that was a single, nonrecurring event in the past ~~should~~shall not be changed."***{add italics}*** (emphasis added.)  
~~FN37FN33~~

~~FN37 Opinion 20, paragraph 16 [paragraph 250-10-45-12]FN33 FASB ASC paragraph 250-10-45-12.~~

30. Amend paragraph 932-10-S99-2, with no link to a transition paragraph, as follows:

**Extractive Activities—Oil and Gas—Overall**

**SEC Materials**

**> SEC Staff Guidance**

**> > Staff Accounting Bulletins**

**> > > SAB Topic 2.D, Financial Statements of Oil and Gas Exchange Offers**

**932-10-S99-2** The following is the text of SAB Topic 2.D, Financial Statements of Oil and Gas Exchange Offers.

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

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, Statement 69 (Subtopic 932-235) 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. FN2FN13 These disclosures may, however, be presented on a combined basis if the entities are under common control.

FN2 See SAB 40, Topic 12.A.3.c (see paragraph 932-235 S99-1).

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.

~~FN13 See SAB 40, Topic 12.A.3.c (see paragraph 932-235 S99-1).~~

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 (Subtopic 932-360), 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 (Subtopic 932-10), 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 retroactively.

Question 4: What pro forma financial information is required in an exchange offering?

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. ~~FN3~~~~FN4~~ Rule 11-02(b) specifies the presentation requirements, including periods presented and types of adjustments to be made. The general criteria of Rule 11-02(b)(6) are that pro forma adjustments should give effect to events that are (i) directly attributable to the transaction, (ii) expected to have a continuing impact on the registrant, and (iii) factually supportable. In the case of an exchange offer, such adjustments typically are made to:

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

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

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

(4) Reflect the acquisition in the pro forma statements where the exchange offer is accounted for using the acquisition method of accounting, including depreciation, depletion and amortization based on the measurement guidance in FASB ASC Topic 805, Business Combinations, Statement 141(R) (Topic 805).

(5) Provide pro forma reserve information comparable to the disclosures required by FASB ASC paragraphs 932-235-50-3 through 932-235-50-11B and FASB ASC paragraphs 932-235-50-29 through 932-235-50-36, paragraphs 10 through 17 and 30 through 34 of Statement 69 (Subtopic 932-235).

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

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

~~FN3FN14~~ As announced in Financial Reporting Release No. 2 (July 9, 1982).

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

A. Acquisition Method Accounting.

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

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

#### B. Common Control Accounting.

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

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

31. Amend paragraph 932-235-S99-1, with no link to a transition paragraph, as follows:

#### **Extractive Activities—Oil and Gas—Notes to Financial Statements**

##### **SEC Materials**

##### **> SEC Staff Guidance**

##### **>> Staff Accounting Bulletins**

##### **>>> SAB Topic 12.A, Accounting Series Release 257—Requirements for Financial Accounting and Reporting Practices for Oil and Gas Producing Activities**

##### **>>>> SAB Topic 12.A.3, Disclosure of Reserve Information**

**932-235-S99-1** The following is the text of SAB Topic 12.A.3, Disclosure of Reserve Information.

c. Limited partnership 10-K reports.

Facts: Securities Act Industry Guide 2 contains an exemption from the requirements of the Guide to disclose certain information relating to oil and gas operations for "limited partnerships or joint ventures that conduct, operate, manage, or report upon oil and gas drilling income programs which acquire properties either for drilling and production, or for production of oil, gas, or geothermal steam." ~~Regulation S-X does not contain a similar exemption from the supplemental disclosure requirements of Statement 69 [Section 932-235-50].~~

Limited partnership agreements often contain buy-out provisions under which the general partner agrees to purchase limited partnership interests that are offered for sale, based upon a specified valuation formula. Because of these arrangements, the requirements for disclosure of reserve value information may be of little significance to the limited partners.

Question: Must the financial statements of limited partnerships included in reports on Form 10-K contain the disclosures of estimated future net revenues, present values and changes therein, and supplemental summary of oil and gas activities specified in FASB ASC paragraphs 932-235-50-23 through 932-235-50-36 (Extractive Activities—Oil and Gas Topic)? ~~by paragraphs 24-34 of Statement 69 [paragraphs 932-235-50-23 through 50-36]?~~

Interpretive Response: The staff will not take exception to the omission of these disclosures in a limited partnership Form 10-K if reserve value information is available to the limited partners pursuant to the partnership agreement (even though the valuations may be computed differently and may be as of a date other than year end). However, the staff will require all of the information listed in FASB ASC paragraphs 932-235-50-23 through 932-235-50-36 ~~specified by these paragraphs of Statement 69 [Section 932-235-50]~~ for partnerships which are the subject of a merger or exchange offer under which various limited partnerships are to be combined into a single entity.

d. Limited partnership registration statements.

Facts: ~~The staff requires that a registration statement relating to an offering of limited partnership interests include the most recent year-end balance sheet of the general partner. This is considered necessary for purposes of assessing the financial responsibility of the general partner.~~

Question: ~~What disclosures of oil and gas reserve information must accompany the balance sheet of the general partner?~~

Interpretive Response: ~~Disclosures should include oil and gas reserve information that pertains to the balance sheet, i.e., the estimated year-end quantities of proved oil and gas reserves and the estimated future net~~

~~revenues and present values thereof specified by paragraphs 10-17 and 30-34, respectively, of Statement 69 [paragraphs 932-235-50-3 through 50-11 and 932-235-50-29 through 50-36].~~

e. Rate regulated companies.

Question: If a company has cost-of-service oil and gas producing properties, how should they be treated in the supplemental disclosures of reserve quantities and related future net revenues provided pursuant to FASB ASC paragraphs 932-235-50-29 through 932-235-50-36~~paragraphs 30-34 of Statement 69 [932-235-50-3 through 50-11 and 932-235-50-29 through 50-36]~~?

Interpretive Response: Rule 4-10 provides that registrants may give effect to differences arising from the ratemaking process for cost-of-service oil and gas properties. Accordingly, in these circumstances, the staff believes that the company's supplemental reserve quantity disclosures should indicate separately the quantities associated with properties subject to cost-of-service ratemaking, and that it is appropriate to exclude those quantities from the future net revenue disclosures. The company should also disclose the nature and impact of its cost-of-service ratemaking, including the unamortized cost included in the balance sheet.

32. Amend paragraph 932-360-S99-2 and replace the table in Question 2, with no link to a transition paragraph, as follows:

## **Extractive Activities—Oil and Gas—Property, Plant, and Equipment**

### **SEC Materials**

#### **> SEC Staff Guidance**

#### **>> Staff Accounting Bulletins**

#### **>>> SAB Topic 12.D, Application of Full Cost Method of Accounting**

**932-360-S99-2** The following is the text of SAB Topic 12.D, Application of Full Cost Method of Accounting.

1. Treatment of Income Tax Effects in the Computation of the Limitation on Capitalized Costs

Facts: Item (D) of Rule 4-10(c)(4)(i) of Regulation S-X states that the income tax effects related to the properties involved should be deducted in computing the full cost ceiling.

Question 1: What specific types of income tax effects should be considered in computing the income tax effects to be deducted from estimated future net revenues?

Interpretive Response: The rule refers to income tax effects generally. Thus, the computation should take into account (i) the tax basis of oil and gas properties, (ii) net operating loss carryforwards, (iii) foreign tax credit carryforwards, (iv) investment tax credits, (v) minimum taxes on tax preference items, and (vi) the impact of statutory (percentage) depletion.

It may often be difficult to allocate net operating loss carryforwards (NOLs) between oil and gas assets and other assets. However, to the extent that the NOLs are clearly attributable to oil and gas operations and are expected to be realized within the carryforward period, they should be added to tax basis.

Similarly, to the extent that investment tax credit (ITC) carryforwards and foreign tax credit carryforwards are attributable to oil and gas operations and are expected to be realized within the carryforward period, they should be considered as a deduction from the tax effect otherwise computed. Consideration of NOLs and ITC or foreign tax credit carryforwards should not, of course, reduce the total tax effect below zero.

Question 2: How should the tax effect be computed considering the various factors discussed above?

Interpretive Response: Theoretically, taxable income and tax could be determined on a year-by-year basis and the present value of the related tax computed. However, the "shortcut" method illustrated below is also acceptable.

**[For ease of readability, the table below is not underlined as new text. The old table is not shown here.]**

<b>ASSUMPTIONS:</b>			
Cost of proved properties being amortized		\$ 396,000	
Lower of cost or estimated fair value of unproved properties to be amortized		49,000	
Cost of properties not being amortized		55,000	
Capitalized costs of oil and gas assets		500,000	
Accumulated DD&A		(100,000)	
Book basis of oil and gas assets			\$ 400,000
Excess of book basis over tax basis (\$270,000) of oil and gas assets		\$ (130,000)	
NOL carryforward *		20,000	
		(110,000)	
Statutory tax rate (percent)		x 46%	
		(50,600)	
Foreign tax credit carryforward *		1,000	
ITC carryforward *		2,000	
Related net deferred income tax liability			(47,600)
Net book basis to be recovered			\$ 352,400
Other Assumptions:			
Present value of ITC relating to future development costs		\$ 1,500	
Present value of statutory depletion attributable to future deductions		\$ 10,000	
Estimated preference (minimum) tax on percentage depletion in excess of cost depletion		\$ 500	
Present value of future net revenue from proved oil and gas reserves		\$ 272,000	
<b>CALCULATION:</b>			
Present value of future net revenue		\$ 272,000	
Cost of properties not being amortized		55,000	
Lower of cost or estimated fair value of unproved properties included in costs being amortized		49,000	
Total ceiling limitation before tax effects			\$ 376,000
Tax Effects:			
Total ceiling limitation before tax effects		\$ 376,000	
Less: Tax basis of properties	(270,000)		
Statutory depletion	(10,000)		
NOL carryforward	(20,000)		
		(300,000)	
Future taxable income		76,000	
Tax rate (percent)		x 46%	
Tax at statutory rate		(34,960)	
ITC (future development costs and carryforward)		3,500	
Foreign tax credit carryforward		1,000	
Estimated preference tax		(500)	
Net tax effects			(30,960)
Cost Center Ceiling			\$ 345,040
Less: Net book basis to be recovered			352,400
REQUIRED WRITE-OFF, net of tax **			\$ (7,360)

\* All carryforward amounts in this example represent amounts which are available for tax purposes and which relate to oil and gas operations.

\*\* For accounting purposes, the gross write-off should be recorded to adjust both the oil and gas properties account and the related deferred income taxes.



### 3. Full Cost Ceiling Limitation

#### a. Exemptions for purchased properties.

Facts: During 20x1, a registrant purchases proved oil and gas reserves in place ("the purchased reserves") in an arm's length transaction for the sum of \$9.8 million. Primarily because the registrant expects oil and gas prices to escalate, it paid \$1.2 million more for the purchased reserves than the "Present Value of Estimated Future Net Revenues" computed as defined in Rule 4-10(c)(4)(i)(A) of Regulation S-X. An analysis of the registrant's full cost center in which the purchased reserves are located at December 31, 20x1 is as follows:

	(Amounts in 1,000)			
	Total	Purchased Reserves	Other Proved Properties	Unproved Properties
Present value of estimated	\$ 14,100	8,600	5,500	-
Cost, net of amortization	<u>\$ 16,300</u>	<u>9,800</u>	<u>5,500</u>	<u>1,000</u>
Related deferred taxes	\$ 2,300	-	2,000	300
Income tax effects related to properties	<u>\$ 2,500</u>	<u>-</u>	<u>2,500</u>	<u>-</u>
Comparison of capitalized costs with limitation on capitalized costs at		Including Purchased Reserves	Excluding Purchased Reserves	
Capitalized costs, net of amortization		\$ 16,300	\$ 6,500	
Related deferred taxes		<u>(2,300)</u>	<u>(2,300)</u>	
Net book cost		<u>14,000</u>	<u>4,200</u>	
Present value of estimated future net revenues		14,100	\$ 5,500	
Lower of cost or market of unproved properties		1,000	1,000	
Income tax effects related to properties		<u>(2,500)</u>	<u>(2,500)</u>	
Limitation on capitalized costs		<u>12,600</u>	<u>4,000</u>	
Excess of capitalized costs over limitation on capitalized costs, net of tax		<u>\$ 1,400</u>	<u>\$ 200</u>	

\* For accounting purposes, the gross write-off should be recorded to adjust both the oil and gas properties account and the related deferred income taxes

Question: Is it necessary for the registrant to write down the carrying value of its full cost center at December 31, 20x1 by \$1,400,000?

Interpretive Response: Although the net carrying value of the full cost center exceeds the cost center's limitation on capitalized costs, the text of ASR 258 provides that a registrant may request an exemption from the rule if as a result of a major purchase of proved properties, a write down would be required even though the registrant believes the fair value of the properties in a cost center clearly exceeds the unamortized costs.

Therefore, to the extent that the excess carrying value relates to the purchased reserves, the registrant may seek a temporary waiver of the full-cost ceiling limitation from the staff of the Commission. Registrants requesting a waiver should be prepared to demonstrate that the additional value exists beyond reasonable doubt.

To the extent that the excess costs relate to properties other than the purchased reserves, however, a write-off should be recorded in the current period. In order to determine the portion of the total excess carrying value which is attributable to properties other than the purchased reserves, it is necessary to perform the ceiling computation on a "with and without" basis as shown in the example above. Thus in this case, the registrant must record a write-down of \$200,000 applicable to other reserves. An additional \$1,200,000 write-down would be necessary unless a waiver were obtained.

b. Use of cash flow hedges in the computation of the limitation on capitalized costs.

Facts: Rule 4-10(c)(4) of Regulation S-X provides, in pertinent part, that capitalized costs, net of accumulated depreciation and amortization, and deferred income taxes, should not exceed an amount equal to the sum of [components that include] the present value of estimated future net revenues computed by applying current prices of oil and gas reserves (with consideration of price changes only to the extent provided by contractual arrangements) to estimated future production of proved oil and gas reserves as of the date of the latest balance sheet presented.

As of the reported balance sheet date, capitalized costs of an oil and gas producing company exceed the full cost limitation calculated under the above described rule based on current spot market prices for oil and natural gas. However, prior to the balance sheet date, the company enters into certain hedging arrangements for a portion of its future natural gas and oil production, thereby enabling the company to receive future cash flows that are higher than the estimated future cash flows indicated by use of the spot market price as of the reported balance sheet date. These arrangements qualify as cash flow hedges under the provisions of FASB ASC Topic 815, Derivatives and Hedging, Statement 133 [Topic 815] as amended and interpreted, and are documented, designated, and accounted for as such under the criteria of that standard.

Question: Under these circumstances, must the company use the higher prices to be received after taking into account the hedging arrangements ("hedge-adjusted prices") in calculating the current price of the quantities of its future production of oil and gas reserves covered by the hedges as of the reported balance sheet date?

Interpretive Response: Yes. Derivative contracts that qualify as hedging instruments in a cash flow hedge and are accounted for as such pursuant to FASB ASC Topic 815, Statement 133 [Topic 815] represent the type of contractual arrangements for which consideration of price changes should be given under the existing rule. While the SEC staff has objected to previous proposals to consider various hedging techniques as being equivalent to the contractual arrangements permitted under the existing rules, the staff's objection was based on concerns that the lack of clear,

consistent guidance in the accounting literature would lead to inconsistent application in practice. For example, prior to the adoption of Statement 133 [Topic 815], hedging activities related to foreign exchange rates were addressed in Statement 52 [Topic 830]. The use of futures contracts as hedging arrangements was previously addressed in Statement 80. The guidance provided in these Statements differed from Statement 133 [Topic 815] in the criteria used to qualify for hedge accounting. However, the staff believes that FASB ASC Topic 815 Statement 133 [Topic 815] and related guidance (including a more systematic approach to documentation) provides sufficient guidance so that comparable financial reporting in comparable factual circumstances should result.

This interpretive response reflects the SEC staff's view that, assuming compliance with the prerequisite accounting requirements, hedge adjusted prices represent the best measure of estimated cash flows from future production of the affected oil and gas reserves to use in calculating the ceiling limitation. ~~{delete paragraph return}~~ Nonetheless, the staff expects that oil and gas producing companies subject to the full cost rules will clearly indicate the effects of using cash flow hedges in calculating ceiling limitations within their financial statement footnotes. The staff further expects that disclosures will indicate the portion of future oil and gas production being hedged. The dollar amount that would have been charged to income had the effects of the cash flow hedges not been considered in calculating the ceiling limitation also should be disclosed.

The use of hedge-adjusted prices should be consistently applied in all reporting periods, including periods in which the hedge-adjusted price is less than the current spot market price. Oil and gas producers whose computation of the ceiling limitation includes hedge-adjusted prices because of the use of cash flow hedges also should consider the disclosure requirements under FASB ASC Section 275-10-50, Risks and Uncertainties—Overall—Disclosure. ~~the SOP 94-6 [Section 275-10-50]. FASB ASC paragraph 275-10-50-9~~ Paragraph 14 of SOP 94-6 [paragraph 275-10-50-9] calls for disclosure when it is at least reasonably possible that the effects of cash flow hedges on capitalized costs on the reported balance sheet date will change in the near term due to one or more confirming events, such as potential future changes in commodity prices.

In addition, the use of cash flow hedges in calculating the ceiling limitation may represent a type of critical accounting policy that oil and gas producers should consider disclosing consistent with the cautionary advice provided in FR 60. Through this release, the Commission has encouraged companies to include, within their MD&A disclosures, full explanations, in plain English, of the judgments and uncertainties affecting the application of critical accounting policies, and the likelihood that materially different amounts would be reported under different conditions or using different assumptions.

The staff's guidance on this issue would apply to calculations of ceiling limitations both in interim and annual periods.

c. Effect of subsequent events on the computation of the limitation on capitalized costs.

Facts: Rule 4-10(c)(4)(ii) of Regulation S-X provides that an excess of unamortized capitalized costs within a cost center over the related cost ceiling shall be charged to expense in the period the excess occurs.

Question: Assume that at the date of company's fiscal year-end, its capitalized costs of oil and gas producing properties exceed the limitation prescribed by Rule 4-10(c)(4) of Regulation S-X. Thus, a write down is indicated. Subsequent to year-end but before the date of the auditors' report on the company's financial statements, assume that ~~one of two events occurs: (1) additional reserves are proved up (excluding the effect of increased oil and gas prices subsequent to year-end) on properties owned at year-end, or (2) price increases become known which were not fixed and determinable at year-end.~~ The present value of future net revenues from the additional reserves ~~or from the increased prices~~ is sufficiently large that if the full cost ceiling limitation were recomputed giving effect to those factors as of year-end, the ceiling would more than cover the costs. It is necessary to record a write down?

Interpretive Response: No. ~~In this case, these cases,~~ the proving up of additional reserves on properties owned at year-end or the increase in prices indicates that the capitalized costs were not in fact impaired at year-end. However, for purposes of the revised computation of the "ceiling," the net book costs capitalized as of year-end should be increased by the amount of any additional costs incurred subsequent to year-end to prove the additional reserves or by any related costs previously excluded from amortization.

While the fact pattern described herein relates to annual periods, the guidance on the effects of subsequent events applies equally to interim period calculations of the ceiling limitation. ~~However, the staff cautions registrants that the process of considering subsequent price changes in the determination of whether a ceiling write-down is called for should be similar to the consideration given to other subsequent events under the auditing literature. The staff expects that the date selected for the ceiling recomputation will be consistent from period to period, and bear a logical relationship to the filing date of the affected financial statements. For example, it would seem logical that an oil and gas producing company would consistently make whatever recalculations are necessary at the date the auditors are completing their interim reviews.~~

The registrant's financial statements should disclose that capitalized costs exceeded the limitation thereon at year-end and should explain why the excess was not charged against earnings. In addition, the registrant's

supplemental disclosures of estimated proved reserve quantities and related future net revenues and costs should not give effect to the reserves proved up or the cost incurred after year-end or to the price increases occurring after year-end. However, such quantities and amounts may be disclosed separately, with appropriate explanations.

Registrants should be aware that oil and gas reserves related to properties acquired after year-end would not justify avoiding a write-off indicated as of year-end. Similarly, the effects of cash flow hedging arrangements entered into after year-end cannot be factored into the calculation of the ceiling limitation at year-end. Such acquisitions and financial arrangements do not confirm situations existing at year-end.

4. Interaction of FASB ASC Subtopic 410-20, Asset Retirement and Environmental Obligations—Asset Retirement Obligations, Statement 143 [Subtopic 410-20] FN1 and the Full Cost Rules

~~FN1 Statement of Financial Accounting Standards No. 143 (Statement 143), Accounting for Asset Retirement Obligations, is effective for financial statements issued for fiscal years beginning after June 15, 2002.~~

a. Impact of FASB ASC Subtopic 410-20 ~~Statement 143 [Subtopic 410-20]~~ on the full cost ceiling test.

Facts: A company following the full cost method of accounting under Rule 4-10(c) of Regulation S-X must periodically calculate a limitation on capitalized costs, i.e., the full cost ceiling. ~~Prior to adopting Statement 143, in calculating the full cost ceiling a company reduced the expected future revenues from proved oil and gas reserves by the estimated future expenditures to be incurred in developing and producing such reserves discounted using a factor specified in the rule. While expected future cash flows related to the asset retirement obligation (ARO) were included in the calculation of the ceiling test, no associated asset was recorded. Under FASB ASC Subtopic 410-20, Statement 143 [Subtopic 410-20], a company must recognize a liability for an asset retirement obligation (ARO) at fair value in the period in which the obligation is incurred, if a reasonable estimate of fair value can be made. The company also must initially capitalize the associated asset retirement costs by increasing long-lived oil and gas assets by the same amount as the liability. Any asset retirement costs capitalized pursuant to FASB ASC Subtopic 410-20, Statement 143 [Subtopic 410-20] are subject to the full cost ceiling limitation under Rule 4-10(c)(4) of Regulation S-X. If after adoption of Statement 143, a company were to continue calculating the full cost ceiling by reducing expected future net revenues by the cash flows required to settle the ARO, then the effect would be to "double-count" such costs in the ceiling test. The assets that must be recovered would be increased while the future net revenues available to recover the assets continue to be reduced by the amount of the ARO settlement cash flows.~~

~~Question 4: How~~After adopting Statement 143, how should a company compute the full cost ceiling to avoid double-counting the expected future cash outflows associated with asset retirement costs?

~~Interpretive Response: The~~After adoption of Statement 143, the future cash outflows associated with settling AROs that have been accrued on the balance sheet should be excluded from the computation of the present value of estimated future net revenues for purposes of the full cost ceiling calculation. ~~FN1, FN2~~~~FN2, FN3~~

~~FN1~~~~FN2~~ If an obligation for expected asset retirement costs has not been accrued under FASB ASC Subtopic 410-20~~Statement 143 [Subtopic 410-20]~~ for certain asset retirement costs required to be included in the full cost ceiling calculation under Rule 4-10(c)(4), such costs should continue to be included in the full cost ceiling calculation.

~~FN2~~~~FN3~~ This approach is consistent with the guidance in FASB ASC Subtopic 410-20~~paragraph 12 of Statement 143 [paragraphs 360-10-35-18 through 35-19]~~ on testing for impairment under FASB ASC Section 360-10-35, Property, Plant, and Equipment—Overall—Subsequent Measurement~~Statement of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets~~. Under that guidance, the asset tested should include capitalized asset retirement costs. The estimated cash flows related to the associated ARO that has been recognized in the financial statements are to be excluded from both the undiscounted cash flows used to test for recoverability and the discounted cash flows used to measure the asset's fair value.

~~Question 2: What disclosures should the company provide on the interaction of Statement 143 [Subtopic 410-20] and the full cost rules?~~

~~Interpretive Response: In order to inform financial statement users on the interaction of Statement 143 [Subtopic 410-20] and the full cost rules, a company following such rules is expected to provide appropriate disclosures in the financial statement footnotes and Management's Discussion and Analysis explaining in detail how the adoption of Statement 143 impacts its accounting for oil and gas operations. This disclosure is expected to address each area of accounting that is impacted or expected to be impacted and should specifically address each way that the company's application of full cost accounting has changed as a result of adoption of Statement 143. These disclosures and discussions should include, but are not limited to, how the company's calculation of the ceiling test and depreciation, depletion, and amortization are affected by the adoption of Statement 143.~~

b. Impact of FASB ASC Subtopic 410-20~~Statement 143 [Subtopic 410-20]~~ on the calculation of depreciation, depletion, and amortization.

Facts: Regarding the base for depreciation, depletion, and amortization (DD&A) of proved reserves, Rule 4-10(c)(3)(i) of Regulations S-X states that "[c]osts to be amortized shall include (A) all capitalized costs, less accumulated amortization, other than the cost of properties described in paragraph (ii) below; FN3FN4 (B) the estimated future expenditures (based on current costs) to be incurred in developing proved reserves; and (C) estimated dismantlement and abandonment costs, net of estimated salvage values." FASB ASC Subtopic 410-20Statement 143 [Subtopic 410-20] requires that upon initial recognition of an ARO, the associated asset retirement costs be included in the capitalized costs of the company. Therefore, subsequent to the adoption of Statement 143, the estimated dismantlement and abandonment costs described in (C) above may be included in the capitalized costs described in (A) above, at least to the extent that an ARO has been incurred as a result of acquisition, exploration and development activities to date. Future development activities on proved reserves may result in additional asset retirement obligations when such activities are performed and the associated asset retirement costs will be capitalized at that time.

FN3FN4 The reference to "cost of properties described in paragraph (ii) below" relates to the costs of investments in unproved properties and major development projects, as defined.

Question: ~~Should~~Following the adoption of Statement 143, should the costs to be amortized under Rule 4-10(c)(3) of Regulation S-X include an amount for estimated dismantlement and abandonment costs, net of estimated salvage values, that are expected to result from future development activities?

Interpretive Response: Yes. ~~To the extent that estimated dismantlement and abandonment costs, net of estimated salvage values, have not been included as capitalized costs in the base for computing DD&A because they have not yet been capitalized as asset retirement costs under Statement 143 [Subtopic 410-20], compliance with Rule 4-10(c)(3) of Regulation S-X continues to require that they be included in the base for computing DD&A.~~ Companies should estimate the amount of dismantlement and abandonment costs that will be incurred as a result of future development activities on proved reserves and include those amounts in the costs to be amortized.

#### ~~e. Transition.~~

Question: ~~When will registrants be expected to comply with the accounting and disclosures described in this bulletin?~~

Interpretive Response: ~~All registrants are expected to apply the accounting and disclosures described in this bulletin prospectively as of the beginning of the first fiscal quarter beginning after the publication of this bulletin in the Federal Register. If a registrant files financial statements with the~~

~~Commission before applying the guidance in this bulletin, disclosures similar to those described in Staff Accounting Bulletin Topic 11 M should be provided.~~

33. Amend paragraph 942-810-S99-1, with no link to a transition paragraph, as follows:

## **Financial Services—Depository and Lending—Consolidation**

### **SEC Materials**

#### **> SEC Staff Guidance**

#### **> > Staff Accounting Bulletins**

#### **> > > SAB Topic 5.V, Certain Transfer of Non-performing Assets**

**942-810-S99-1** The following is the text of SAB Topic 5.V, Certain Transfer of Non-performing Assets.

Facts: A financial institution desires to reduce its nonaccrual or reduced rate loans and other nonearning assets, including foreclosed real estate (collectively, "nonperforming assets"). Some or all of such nonperforming assets are transferred to a newly-formed entity (the "new entity"). The financial institution, as consideration for transferring the nonperforming assets, may receive (a) the cash proceeds of debt issued by the new entity to third parties, (b) a note or other redeemable instrument issued by the new entity, or (c) a combination of (a) and (b). The residual equity interests in the new entity, which carry voting rights, initially owned by the financial institution, are transferred to outsiders (for example, via distribution to the financial institution's shareholders or sale or contribution to an unrelated third party).

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

~~Statement 140 [Topic 860]~~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 ~~Statement 140 [Topic 860]~~FASB ASC Topic 860. Because ~~Statement 140 [Topic 860]~~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 ~~Interpretation 46 [Topic 810]~~ 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. ~~SAB Topic 5.E FN47 discusses some factors that the staff believes should be considered in determining whether the risks of a business have been transferred. Consistent with the factors discussed in SAB Topic 5.E, the~~ FN38 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, ~~FN48~~ FN39 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.

~~FN47 SAB Topic 5.E addresses the accounting for the transfer of certain operations whereby there is a continuing involvement by the seller or other evidence that incidents of ownership remain with the seller.~~ FN38 [Original footnote removed by SAB 114.]

~~FN48~~ FN39 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.

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 ~~FN49~~FN40 over the fair value. ~~FN50~~FN41 Fair value is the amount that would be realizable in an outright sale to an unrelated third party for cash. ~~FN54~~FN42 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.

~~FN49~~FN40 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.

~~FN50~~FN41 The staff notes that the EITF reached a consensus at its November 17, 1988 meeting on Issue 88-25 [~~paragraph 942-810-45-2~~]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.

~~FN51~~FN42 The EITF reached a consensus on issue 11 of Issue 01-02 [~~paragraph 845-10-30-10~~]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.

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. ~~FN52~~FN43

~~FN52FN43~~ 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.

34. Amend paragraph 944-20-S99-1, with no link to a transition paragraph, as follows:

## **Financial Services—Insurance—Insurance Activities**

### **SEC Materials**

#### **> SEC Staff Guidance**

#### **> > Staff Accounting Bulletins**

#### **> > > SAB Topic 5.N, Discounting by Property-Casualty Insurance Companies**

**944-20-S99-1** The following is the text of SAB Topic 5.N, Discounting by Property-Casualty Insurance Companies.

Facts: A registrant which is an insurance company discounts certain unpaid claims liabilities related to short-duration ~~FN9FN43~~ 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.

~~FN9FN43~~ The term "short-duration" refers to the period of coverage (see FASB ASC paragraph 944-20-15-7 (Financial Services—Insurance Topic), Statement 60, paragraph 7 (paragraph 944-20-15-7)), not the period that the liabilities are expected to be outstanding.

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~~ the payment pattern and ultimate cost are fixed and determinable on an individual claim basis, and

(2) ~~The~~ 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. ~~APB Opinion 20 [Topic 250]~~. 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 ~~APB Opinion 20 [Topic 250]~~ concerning the change in accounting principle, a preferability letter from the registrant's independent accountant is required.

35. Amend paragraph 944-40-S99-1, with no link to a transition paragraph, as follows:

**Financial Services—Insurance—Claim Costs and Liabilities for Future Policy Benefits**

**SEC Materials**

**> SEC Staff Guidance**

**>> Staff Accounting Bulletins**

**>>> SAB Topic 5.W, Contingency Disclosures Regarding Property-Casualty Insurance Reserves for Unpaid Claim Costs**

**944-40-S99-1** The following is the text of SAB Topic 5.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, Statement 60 for unpaid claim costs, including estimates of costs relating to claims incurred but not reported ("IBNR"). FN44FN53 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.

~~FN44FN53 FASB ASC paragraph 944-40-30-1 Paragraph 18 of Statement 60 prescribes that "[t]he liability for unpaid claims shall be based on the estimated ultimate cost of settling the claims (including the effects of inflation and other societal and economic factors), using past experience adjusted for current trends, and any other factors that would modify past experience." [Footnote reference omitted]~~

FASB ASC Topic 450, Contingencies, Statement 5 requires, among other things, disclosure of loss contingencies. FN45FN54 However, FASB ASC paragraph 450-10-05-6 paragraph 2 of that Statement notes that FN-"[n]ot all uncertainties inherent in the accounting process give rise to contingencies," ~~as that term is used in [Statement 5]."~~

~~FN45FN54 FASB ASC paragraphs 450-20-50-3 through 450-20-50-4 provide guidance Paragraph 10 of Statement 5 specified that "[i]f no accrual is made for a loss contingency because one or both of the conditions in FASB ASC paragraph 450-20-25-2 paragraph 8 are not met, **{add italics}** or if an exposure to loss exists in excess of the amount accrued **{add italics}** pursuant to the provisions of FASB ASC paragraph 450-20-25-2, paragraph 8), disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred. The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made." [Footnote reference omitted and emphasis added.]~~

FASB ASC Topic 275, Risks and Uncertainties, FN46SOP 94-6 FN55 also provides disclosure guidance regarding certain significant estimates.

FN46FN55 FASB ASC Topic 275SOP 94-6 provides that disclosures regarding certain significant estimates should be made

when ~~certain~~the following criteria are met. The guidance~~SOP~~ provides ~~that~~ 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.

Question 1: In the staff's view, do FASB ASC Topics 450 and 275~~Statement 5 and SOP 94-6~~ disclosure requirements apply to property-casualty insurance reserves for unpaid claim costs? If so, how?

Interpretive Response: Yes. The staff believes that specific uncertainties (conditions, situations and/or sets of circumstances) not considered to be normal and recurring because of their significance and/or nature can result in loss contingencies ~~FN47FN56~~ for purposes of applying FASB ASC Topics 450 and 275~~Statement 5 and SOP 94-6~~ disclosure requirements. General uncertainties, such as the amount and timing of claims, that are normal, recurring, and inherent to estimations of property-casualty insurance reserves are not considered subject to the disclosure requirements of FASB ASC Topic 450~~Statement 5~~. Some specific uncertainties that may result in loss contingencies pursuant to FASB ASC Topic 450~~Statement 5~~, depending on significance and/or nature, include insufficiently understood trends in claims activity; judgmental adjustments to historical experience for purposes of estimating future claim costs (other than for normal recurring general uncertainties); significant risks to an individual claim or group of related claims; or catastrophe losses. The requirements of FASB ASC Topic 275~~SOP 94-6~~ 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."

~~FN47FN56~~ The loss contingency referred to in this document is the potential for a material understatement of reserves for unpaid claims.

Question 2: Do the facts presented above describe an uncertainty that requires disclosures under FASB ASC Topics 450 and 275~~Statement 5 and SOP 94-6~~?

Interpretive Response: Yes. The staff believes the judgmental adjustments to historical experience for insufficiently understood claims activity noted above results in a loss contingency within the scope of FASB ASC Topics 450 and 275, Statement 5 and SOP 94-6. Based on the facts presented above, at a minimum the Company's financial statements should disclose that for purposes of estimating IBNR claim reserves, past experience was adjusted for what management believes to be abnormal claims experience related to the recent acquisition of Company A and accelerated claims processing. It should also be disclosed that there is a reasonable possibility that the claims experience could be the indication of an unfavorable trend which would require additional IBNR claim reserves in the approximate range of \$XX-\$XX million (alternatively, if Company management is unable to estimate the possible loss or range of loss, a statement to that effect should be disclosed).

Additionally, the staff also expects companies to disclose the nature of the loss contingency and the potential impact on trends in their loss reserve development discussions provided pursuant to Property-Casualty Industry Guides 4 and 6. Consideration should also be given to the need to provide disclosure in MD&A.

Question 3: Does the staff have an example in which specific uncertainties involving an individual claim or group of related claims result in a loss contingency the staff believes requires disclosure?

Interpretive Response: Yes. A property-casualty insurance company (the "Company") underwrites product liability insurance for an insured manufacturer which has produced and sold millions of units of a particular product which has been used effectively and without problems for many years. Users of the product have recently begun to report serious health problems that they attribute to long term use of the product and have asserted claims under the insurance policy underwritten and retained by the Company. To date, the number of users reporting such problems is relatively small, and there is presently no conclusive evidence that demonstrates a causal link between long term use of the product and the health problems experienced by the claimants. However, the evidence generated to date indicates that there is at least a reasonable possibility that the product is responsible for the problems and the assertion of additional claims is considered probable, and therefore the potential exposure of the Company is material. While an accrual may not be warranted since the loss exposure may not be both probable and estimable, in view of the reasonable possibility of material future claim payments, the staff believes that disclosures made in accordance with FASB ASC Topics 450 and 275, Statement 5 and SOP 94-6 would be required under these circumstances.

The disclosure concepts expressed in this example would also apply to an individual claim or group of claims that are related to a single catastrophic event or multiple events having a similar effect.

## Section B: Amendments Pursuant to the Issuance of SEC Final Rule Technical Amendments

*This Accounting Standards Update amends various SEC paragraphs pursuant to the issuance of the SEC's Final Rule, "Technical Amendments to Commission Rules and Forms Related to the FASB's Accounting Standards Codification," Release Nos. 33-9250, 34-65052, and IC-29748 August 8, 2011, as described in the instructions below.*

36. The following amendments reflect the issuance of the SEC's technical amendments final rule.

37. Amend paragraph 205-10-S99-1, with no link to a transition paragraph, as follows:

### **Presentation of Financial Statements—Overall**

#### **SEC Materials**

##### **> SEC Rules, Regulations, and Interpretations**

##### **> > Regulation S-X**

##### **> > > Regulation S-X Rule 4-01, Form, Order and Terminology**

**205-10-S99-1** The following is the text of Regulation S-X Rule 4-01, Form, Order and Terminology.

(a) Financial statements should be filed in such form and order, and should use such generally accepted terminology, as will best indicate their significance and character in the light of the provisions applicable thereto. The information required with respect to any statement shall be furnished as a minimum requirement to which shall be added such further material information as is necessary to make the required statements, in the light of the circumstances under which they are made, not misleading.

(1) Financial statements filed with the Commission which are not prepared in accordance with generally accepted accounting principles will be presumed to be misleading or inaccurate, despite footnote or other disclosures, unless the Commission has otherwise provided. This article and other articles of Regulation S-X provide

clarification of certain disclosures which must be included in any event, in financial statements filed with the Commission.

(2) In all filings of foreign private issuers (see § 230.405 of this chapter), except as stated otherwise in the applicable form, the financial statements may be prepared according to a comprehensive body of accounting principles other than those generally accepted in the United States if a reconciliation to United States generally accepted accounting principles and the provisions of Regulation S-X of the type specified in Item 18 of Form 20-F (§ 249.220f of this chapter) is also filed as part of the financial statements. Alternatively, the financial statements may be prepared according to United States generally accepted accounting principles.

(3)(i) Notwithstanding the effective dates set forth in FASB ASC Topic 718, Compensation—Stock Compensation, Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (“Statement No. 123R”), financial statements shall be prepared in accordance with FASB ASC Topic 718 Statement No. 123R beginning with:

(A) The first interim or annual reporting period of the registrant's first fiscal year beginning on or after June 15, 2005, provided the registrant does not file as a small business issuer; and

(B) The first interim or annual reporting period of the registrant's first fiscal year beginning on or after December 15, 2005, provided the registrant files as a small business issuer.

(ii) For periods prior to the effective dates set forth in this paragraph, both FASB ASC Topic 718 and prior authoritative guidance Statement No. 123R and Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation (October 1995), shall be considered to be generally accepted accounting principles.

(b) All money amounts required to be shown in financial statements may be expressed in whole dollars or multiples thereof, as appropriate: Provided, That, when stated in other than whole dollars, an indication to that effect is inserted immediately beneath the caption of the statement or schedule, at the top of the money columns, or at an appropriate point in narrative material.

(c) Negative amounts (red figures) shall be shown in a manner which clearly distinguishes the negative attribute. When determining methods of display, consideration should be given to the limitations of reproduction and microfilming processes.

[45 FR 63669, Sept. 25, 1980, as amended at 47 FR 54767, Dec. 6, 1982; 70 FR 20719, Apr. 21, 2005]

38. Amend paragraph 235-10-S99-1, with no link to a transition paragraph, as follows:

### **Notes to Financial Statements—Overall**

#### **SEC Materials**

#### **> SEC Rules, Regulations, and Interpretations**

#### **> > Regulation S-X**

#### **> > > Regulation S-X Rule 4-08, General Notes to Financial Statements**

**235-10-S99-1** The following is the text of Regulation S-X Rule 4-08, General Notes to Financial Statements.

If applicable to the person for which the financial statements are filed, the following shall be set forth on the face of the appropriate statement or in appropriately captioned notes. The information shall be provided for each statement required to be filed, except that the information required by paragraphs (b), (c), (d), (e) and (f) shall be provided as of the most recent audited balance sheet being filed and for paragraph (j) as specified therein. When specific statements are presented separately, the pertinent notes shall accompany such statements unless cross-referencing is appropriate.

(a) Principles of consolidation or combination. With regard to consolidated or combined financial statements, refer to §§ 210.3A–01 to 3A–08 for requirements for supplemental information in notes to the financial statements.

(b) Assets subject to lien. Assets mortgaged, pledged, or otherwise subject to lien, and the approximate amounts thereof, shall be designated and the obligations collateralized briefly identified.

(c) Defaults. The facts and amounts concerning any default in principal, interest, sinking fund, or redemption provisions with

respect to any issue of securities or credit agreements, or any breach of covenant of a related indenture or agreement, which default or breach existed at the date of the most recent balance sheet being filed and which has not been subsequently cured, shall be stated in the notes to the financial statements. If a default or breach exists but acceleration of the obligation has been waived for a stated period of time beyond the date of the most recent balance sheet being filed, state the amount of the obligation and the period of the waiver.

(d) Preferred shares.

(1) Aggregate preferences on involuntary liquidation, if other than par or stated value, shall be shown parenthetically in the equity section of the balance sheet.

(2) Disclosure shall be made of any restriction upon retained earnings that arises from the fact that upon involuntary liquidation the aggregate preferences of the preferred shares exceeds the par or stated value of such shares.

(e) Restrictions which limit the payment of dividends by the registrant.

(1) Describe the most significant restrictions, other than as reported under paragraph (d) of this section, on the payment of dividends by the registrant, indicating their sources, their pertinent provisions, and the amount of retained earnings or net income restricted or free of restrictions.

(2) Disclose the amount of consolidated retained earnings which represents undistributed earnings of 50 percent or less owned persons accounted for by the equity method.

(3) The disclosures in paragraphs (e)(3)(i) and (ii) in this section shall be provided when the restricted net assets of consolidated and unconsolidated subsidiaries and the parent's equity in the undistributed earnings of 50 percent or less owned persons accounted for by the equity method together exceed 25 percent of consolidated net assets as of the end of the most recently completed fiscal year. For purposes of this test, restricted net assets of subsidiaries

shall mean that amount of the registrant's proportionate share of net assets (after intercompany eliminations) reflected in the balance sheets of its consolidated and unconsolidated subsidiaries as of the end of the most recent fiscal year which may not be transferred to the parent company in the form of loans, advances or cash dividends by the subsidiaries without the consent of a third party (i. e., lender, regulatory agency, foreign government, etc.). Not all limitations on transferability of assets are considered to be restrictions for purposes of this test, which considers only specific third party restrictions on the ability of subsidiaries to transfer funds outside of the entity. For example, the presence of subsidiary debt which is secured by certain of the subsidiary's assets does not constitute a restriction under this rule. However, if there are any loan provisions prohibiting dividend payments, loans or advances to the parent by a subsidiary, these are considered restrictions for purposes of computing restricted net assets. When a loan agreement requires that a subsidiary maintain certain working capital, net tangible asset, or net asset levels, or where formal compensating arrangements exist, there is considered to be a restriction under the rule because the lender's intent is normally to preclude the transfer by dividend or otherwise of funds to the parent company. Similarly, a provision which requires that a subsidiary reinvest all of its earnings is a restriction, since this precludes loans, advances or dividends in the amount of such undistributed earnings by the entity. Where restrictions on the amount of funds which may be loaned or advanced differ from the amount restricted as to transfer in the form of cash dividends, the amount least restrictive to the subsidiary shall be used. Redeemable preferred stocks (§ 210.5-02.28) and noncontrolling interests shall be deducted in computing net assets for purposes of this test.

(i) Describe the nature of any restrictions on the ability of consolidated subsidiaries and unconsolidated subsidiaries to transfer funds to the registrant in the form of cash dividends, loans or advances (i. e., borrowing arrangements, regulatory restraints, foreign government, etc.)

(ii) Disclose separately the amounts of such restricted net assets for unconsolidated

subsidiaries and consolidated subsidiaries as of the end of the most recently completed fiscal year.

(f) Significant changes in bonds, mortgages and similar debt. Any significant changes in the authorized or issued amounts of bonds, mortgages and similar debt since the date of the latest balance sheet being filed for a particular person or group shall be stated.

(g) Summarized financial information of subsidiaries not consolidated and 50 percent or less owned persons.

(1) The summarized information as to assets, liabilities and results of operations as detailed in § 210.1-02(bb) shall be presented in notes to the financial statements on an individual or group basis for:

(i) Subsidiaries not consolidated; or

(ii) For 50 percent or less owned persons accounted for by the equity method by the registrant or by a subsidiary of the registrant, if the criteria in § 210.1-02(w) for a significant subsidiary are met:

(A) Individually by any subsidiary not consolidated or any 50% or less owned person; or

(B) On an aggregated basis by any combination of such subsidiaries and persons.

(2) Summarized financial information shall be presented insofar as is practicable as of the same dates and for the same periods as the audited consolidated financial statements provided and shall include the disclosures prescribed by § 210.1-02(bb). Summarized information of subsidiaries not consolidated shall not be combined for disclosure purposes with the summarized information of 50 percent or less owned persons.

(h) Income tax expense.

(1) Disclosure shall be made in the income statement or a note thereto, of (i) the components of income (loss) before income tax expense (benefit) as either domestic or foreign; (ii) the components of income tax expense, including (A) taxes currently payable and (B) the net tax effects, as applicable, of timing differences (indicate separately the amount of the estimated tax effect of each of the various types of timing differences, such as depreciation, warranty costs, etc., where the amount of each such tax effect exceeds five percent of the amount computed by multiplying the income before tax by the applicable statutory Federal income tax rate; other differences may be combined).

NOTE: Amounts applicable to United States Federal income taxes, to foreign income taxes and the other income taxes shall be stated separately for each major component. Amounts applicable to foreign income (loss) and amounts applicable to foreign or other income taxes which are less than five percent of the total of income before taxes or the component of tax expense, respectively, need not be separately disclosed. For purposes of this rule, foreign income (loss) is defined as income (loss) generated from a registrant's foreign operations, i. e., operations that are located outside of the registrant's home country.

(2) Provide a reconciliation between the amount of reported total income tax expense (benefit) and the amount computed by multiplying the income (loss) before tax by the applicable statutory Federal income tax rate, showing the estimated dollar amount of each of the underlying causes for the difference. If no individual reconciling item amounts to more than five percent of the amount computed by multiplying the income before tax by the applicable statutory Federal income tax rate, and the total difference to be reconciled is less than five percent of such computed amount, no reconciliation need be provided unless it would be significant in appraising the trend of earnings. Reconciling items that are individually less than five percent of the computed amount may be aggregated in the reconciliation. The reconciliation may be presented in percentages rather than in dollar amounts.

Where the reporting person is a foreign entity, the income tax rate in that person's country of domicile should normally be used in making the above computation, but different rates should not be used for subsidiaries or other segments of a reporting entity. When the rate used by a reporting person is other than the United States Federal corporate income tax rate, the rate used and the basis for using such rate shall be disclosed.

(3) Paragraphs (h)(1) and (2) of this section shall be applied in the following manner to financial statements which reflect the adoption of FASB ASC Topic 740, Income Taxes, ~~Statement of Financial Accounting Standards 109, Accounting for Income Taxes~~.

(i) The disclosures required by paragraph (h)(1)(ii) of this section and by the parenthetical instruction at the end of paragraph (h)(1) of this section and by the introductory sentence of paragraph (h)(2) of this section shall not apply.

(ii) The instructional note between paragraphs (h) (1) and (2) of this section and the balance of the requirements of paragraphs (h) (1) and (2) of this section shall continue to apply.

(i) Warrants or rights outstanding. Information with respect to warrants or rights outstanding at the date of the related balance sheet shall be set forth as follows:

(1) Title of issue of securities called for by warrants or rights.

(2) Aggregate amount of securities called for by warrants or rights outstanding.

(3) Date from which warrants or rights are exercisable.

(4) Price at which warrant or right is exercisable.

(k) Related party transactions which affect the financial statements.

(1) Related party transactions should be identified and the amounts stated on the face of the balance sheet, income statement, or statement of cash flows.

(2) In cases where separate financial statements are presented for the registrant, certain investees, or subsidiaries, separate disclosure shall be made in such statements of the amounts in the related consolidated financial statements which are (i) eliminated and (ii) not eliminated. Also, any intercompany profits or losses resulting from transactions with related parties and not eliminated and the effects thereof shall be disclosed.

(m) Repurchase and reverse repurchase agreements.

(1) Repurchase agreements (assets sold under agreements to repurchase).

(i) If, as of the most recent balance sheet date, the carrying amount (or market value, if higher than the carrying amount or if there is no carrying amount) of the securities or other assets sold under agreements to repurchase (repurchase agreements) exceeds 10% of total assets, disclose separately in the balance sheet the aggregate amount of liabilities incurred pursuant to repurchase agreements including accrued interest payable thereon.

(ii)

(A) If, as of the most recent balance sheet date, the carrying amount (or market value, if higher than the carrying amount) of securities or other assets sold under repurchase agreements, other than securities or assets specified in paragraph (m)(1)(ii)(B) of this section, exceeds 10% of total assets, disclose in an appropriately captioned footnote containing a tabular presentation, segregated as to type of such securities or assets sold under agreements to repurchase (e. g., U.S. Treasury obligations, U.S. Government agency

obligations and loans), the following information as of the balance sheet date for each such agreement or group of agreements (other than agreements involving securities or assets specified in paragraph (m)(1)(ii)(B) of this section) maturing (1) overnight; (2) term up to 30 days; (3) term of 30 to 90 days; (4) term over 90 days and (5) demand:

(i) The carrying amount and market value of the assets sold under agreement to repurchase, including accrued interest plus any cash or other assets on deposit under the repurchase agreements; and

(ii) The repurchase liability associated with such transaction or group of transactions and the interest rate(s) thereon.

(B) For purposes of paragraph (m)(1)(ii)(A) of this section only, do not include securities or other assets for which unrealized changes in market value are reported in current income or which have been obtained under reverse repurchase agreements.

(iii) If, as of the most recent balance sheet date, the amount at risk under repurchase agreements with any individual counterparty or group of related counterparties exceeds 10% of stockholders' equity (or in the case of investment companies, net asset value), disclose the name of each such counterparty or group of related counterparties, the amount at risk with each, and the weighted average maturity of the repurchase agreements with each. The amount at risk under repurchase agreements is defined as the excess of carrying amount (or market value, if higher than the carrying amount or if there is no carrying

amount) of the securities or other assets sold under agreement to repurchase, including accrued interest plus any cash or other assets on deposit to secure the repurchase obligation, over the amount of the repurchase liability (adjusted for accrued interest). (Cash deposits in connection with repurchase agreements shall not be reported as unrestricted cash pursuant to rule 5-02.1.)

(2) Reverse repurchase agreements (assets purchased under agreements to resell).

(i) If, as of the most recent balance sheet date, the aggregate carrying amount of reverse repurchase agreements (securities or other assets purchased under agreements to resell) exceeds 10% of total assets:

(A) Disclose separately such amount in the balance sheet; and

(B) Disclose in an appropriately captioned footnote:

(1) The registrant's policy with regard to taking possession of securities or other assets purchased under agreements to resell; and

(2) Whether or not there are any provisions to ensure that the market value of the underlying assets remains sufficient to protect the registrant in the event of default by the counterparty and if so, the nature of those provisions.

(ii) If, as of the most recent balance sheet date, the amount at risk under reverse repurchase agreements with any individual counterparty or

group of related counterparties exceeds 10% of stockholders' equity (or in the case of investment companies, net asset value), disclose the name of each such counterparty or group of related counterparties, the amount at risk with each, and the weighted average maturity of the reverse repurchase agreements with each. The amount at risk under reverse repurchase agreements is defined as the excess of the carrying amount of the reverse repurchase agreements over the market value of assets delivered pursuant to the agreements by the counterparty to the registrant (or to a third party agent that has affirmatively agreed to act on behalf of the registrant) and not returned to the counterparty, except in exchange for their approximate market value in a separate transaction.

(n) Accounting policies for certain derivative instruments. Disclosures regarding accounting policies shall include descriptions of the accounting policies used for derivative financial instruments and derivative commodity instruments and the methods of applying those policies that materially affect the determination of financial position, cash flows, or results of operation. This description shall include, to the extent material, each of the following items:

(1) A discussion of each method used to account for derivative financial instruments and derivative commodity instruments;

(2) The types of derivative financial instruments and derivative commodity instruments accounted for under each method;

(3) The criteria required to be met for each accounting method used, including a discussion of the criteria required to be met for hedge or deferral accounting and accrual or settlement accounting (e. g., whether and how risk reduction, correlation, designation, and effectiveness tests are applied);

(4) The accounting method used if the criteria specified in paragraph (n)(3) of this section are not met;

(5) The method used to account for terminations of derivatives designated as hedges or derivatives used to affect directly or indirectly the terms, fair values, or cash flows of a designated item;

(6) The method used to account for derivatives when the designated item matures, is sold, is extinguished, or is terminated. In addition, the method used to account for derivatives designated to an anticipated transaction, when the anticipated transaction is no longer likely to occur; and

(7) Where and when derivative financial instruments and derivative commodity instruments, and their related gains and losses, are reported in the statements of financial position, cash flows, and results of operations.

Instructions to paragraph 4-08(n).

1. For purposes of this paragraph (n), derivative financial instruments and derivative commodity instruments (collectively referred to as "derivatives") are defined as follows:

(i) Derivative financial instruments have the same meaning as defined by generally accepted accounting principles (see ~~FASB ASC Master Glossary~~ ~~Financial Accounting Standards Board ("FASB"), Statement of Financial Accounting Standards No. 119, "Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments," ("FAS 119") paragraphs 5-7, (October 1994))~~), and include futures, forwards, swaps, options, and other financial instruments with similar characteristics.

(ii) Derivative commodity instruments include, to the extent such instruments are not derivative financial instruments, commodity futures, commodity forwards, commodity swaps, commodity options, and other commodity instruments with similar characteristics that are permitted by contract or business custom to be settled in cash or with another financial instrument. For purposes of this paragraph, settlement in cash includes settlement in cash of the net change in value of the derivative commodity instrument (e. g., net cash settlement based on changes in the price of the underlying commodity).

2. For purposes of paragraphs (n)(2), (n)(3), (n)(4), and (n)(7), the required disclosures should address separately derivatives entered into for trading purposes and derivatives entered into for purposes other than trading.

For purposes of this paragraph, trading purposes means dealing and other trading activities measured at fair value with gains and losses recognized in earnings, ~~has the same meaning as defined by generally accepted accounting principles (see, e. g., FAS 119, paragraph 9a (October 1994)).~~

3. For purposes of paragraph (n)(6), anticipated transactions means transactions (other than transactions involving existing assets or liabilities or transactions necessitated by existing firm commitments) an enterprise expects, but is not obligated, to carry out in the normal course of business ~~(see, e. g., FASB, Statement of Financial Accounting Standards No. 80, "Accounting for Futures Contracts," paragraph 9, (August 1984)).~~

4. Registrants should provide disclosures required under paragraph (n) in filings with the Commission that include financial statements of fiscal periods ending after June 15, 1997.

[45 FR 63669, Sept. 25, 1980, as amended at 46 FR 56179, Nov. 16, 1981; 50 FR 25215, June 18, 1985; 50 FR 49532, Dec. 3, 1985; 51 FR 3770, Jan. 30, 1986; 57 FR 45293, Oct. 1, 1992; 59 FR 65636, Dec. 20, 1994; 62 FR 6063, Feb. 10, 1997]

39. Amend paragraph 270-10-S99-1, with no link to a transition paragraph, as follows:

**Interim Reporting—Overall**

**SEC Materials**

**> SEC Rules, Regulations, and Interpretations**

**> > Regulation S-X**

**> > > Regulation S-X Rule 10-01, Interim Financial Statements**

**270-10-S99-1** The following is the text of Regulation S-X Rule 10-01, Interim Financial Statements.

(a) Condensed statements. Interim financial statements shall follow the general form and content of presentation prescribed by the other sections of this Regulation with the following exceptions:

(1) Interim financial statements required by this rule need only be provided as to the registrant and its subsidiaries consolidated and may be unaudited. Separate statements of other entities which may otherwise be required by this regulation may be omitted.

(2) Interim balance sheets shall include only major captions (i. e., numbered captions) prescribed by the applicable sections of this Regulation with the exception of inventories. Data as to raw materials, work in process and finished goods inventories shall be included either on the face of the balance sheet or in the notes to the financial statements, if applicable. Where any major balance sheet caption is less than 10% of total assets, and the amount in the caption has not increased or decreased by more than 25% since the end of the preceding fiscal year, the caption may be combined with others.

(3) Interim statements of income shall also include major captions prescribed by the applicable sections of this Regulation. When any major income statement caption is less than 15% of average net income attributable to the registrant for the most recent three fiscal years and the amount in the caption has not increased or decreased by more than 20% as compared to the corresponding interim period of the preceding fiscal year, the caption may be combined with others. In calculating average net income, loss years should be excluded. If losses were incurred in each of the most recent three years, the average loss shall be used for purposes of this test. Notwithstanding these tests, §210.4-02 applies and de minimis amounts therefore need not be shown separately, except that registrants reporting under § 210.9 shall show investment securities gains or losses separately regardless of size.

(4) The statement of cash flows may be abbreviated starting with a single figure of net cash flows from operating activities and showing cash changes from investing and financing activities individually only when they exceed 10% of the average of net cash flows from operating activities for the most recent three years. Notwithstanding this test, § 210.4-02 applies and de minimis amounts therefore need not be shown separately.

(5) The interim financial information shall include disclosures either on the face of the financial statements or in accompanying

footnotes sufficient so as to make the interim information presented not misleading. Registrants may presume that users of the interim financial information have read or have access to the audited financial statements for the preceding fiscal year and that the adequacy of additional disclosure needed for a fair presentation, except in regard to material contingencies, may be determined in that context. Accordingly, footnote disclosure which would substantially duplicate the disclosure contained in the most recent annual report to security holders or latest audited financial statements, such as a statement of significant accounting policies and practices, details of accounts which have not changed significantly in amount or composition since the end of the most recently completed fiscal year, and detailed disclosures prescribed by Rule 4-08 of this Regulation, may be omitted. However, disclosure shall be provided where events subsequent to the end of the most recent fiscal year have occurred which have a material impact on the registrant. Disclosures should encompass for example, significant changes since the end of the most recently completed fiscal year in such items as: accounting principles and practices; estimates inherent in the preparation of financial statements; status of long-term contracts; capitalization including significant new borrowings or modification of existing financing arrangements; and the reporting entity resulting from business combinations or dispositions. Notwithstanding the above, where material contingencies exist, disclosure of such matters shall be provided even though a significant change since year end may not have occurred.

(6) Detailed schedules otherwise required by this Regulation may be omitted for purposes of preparing interim financial statements.

(7) In addition to the financial statements required by paragraphs (a) (2), (3) and (4) of this section, registrants in the development stage shall provide the cumulative financial statements (condensed to the same degree as allowed in this paragraph) and disclosures required by FASB ASC Topic 915, Development Stage Entities~~Statement of Financial Accounting Standards No. 7, "Accounting and Reporting by Development Stage Enterprises"~~ to the date of the latest balance sheet presented.

(b) Other instructions as to content. The following additional instructions shall be applicable for purposes of preparing interim financial statements:

(1) Summarized income statement information shall be given separately as to each subsidiary not consolidated or 50 percent or

less owned persons or as to each group of such subsidiaries or fifty percent or less owned persons for which separate individual or group statements would otherwise be required for annual periods. Such summarized information, however, need not be furnished for any such unconsolidated subsidiary or person which would not be required pursuant to Rule 13a-13 or 15d-13 to file quarterly financial information with the Commission if it were a registrant.

(2) If appropriate, the income statement shall show earnings per share and dividends declared per share applicable to common stock. The basis of the earnings per share computation shall be stated together with the number of shares used in the computation. In addition, see Item 601(b)(11) of Regulation S-K, (17 CFR 229.601(b)(11)).

(3) If, during the most recent interim period presented, the registrant or any of its consolidated subsidiaries entered into a combination between entities under common control, the interim financial statements for both the current year and the preceding year shall reflect the combined results of the combined businesses. Supplemental disclosure of the separate results of the combined entities for periods prior to the combination shall be given, with appropriate explanations.

(4) Where a material business combination has occurred during the current fiscal year, pro forma disclosure shall be made of the results of operations for the current year up to the date of the most recent interim balance sheet provided (and for the corresponding period in the preceding year) as though the companies had combined at the beginning of the period being reported on. This pro forma information shall, at a minimum, show revenue, income before extraordinary items and the cumulative effect of accounting changes, including such income on a per share basis, net income attributable to the registrant, and net income per share.

(5) Where the registrant has reported a discontinued operation (as required by FASB ASC Subtopic 205-20, Presentation of Financial Statements—Discontinued Operations)~~disposed of any significant segment of its business (as defined in paragraph 13 of Accounting Principles Board Opinion No. 30)~~ during any of the periods covered by the interim financial statements, the effect thereof on revenues and net income— total and per share—for all periods shall be disclosed.

(6) In addition to meeting the reporting requirements specified by existing standards for accounting changes, the registrant shall state the date of any material accounting change and the reasons for making it. In addition, for filings on Form 10-Q and Form 10-QSB, a letter from the registrant's independent accountant shall be filed as an exhibit (in accordance with the provisions of Item 601 of Regulation S-K, 17 CFR 229.601) in the first Form 10-Q and Form 10-QSB subsequent to the date of an accounting change indicating whether or not the change is to an alternative principle which in his judgment is preferable under the circumstances; except that no letter from the accountant need be filed when the change is made in response to a standard adopted by the Financial Accounting Standards Board which requires such change.

(7) Any material retroactive prior period adjustment made during any period covered by the interim financial statements shall be disclosed, together with the effect thereof upon net income—total and per share—of any prior period included and upon the balance of retained earnings. If results of operations for any period presented have been adjusted retroactively by such an item subsequent to the initial reporting of such period, similar disclosure of the effect of the change shall be made.

(8) Any unaudited interim financial statements furnished shall reflect all adjustments which are, in the opinion of management, necessary to a fair statement of the results for the interim periods presented. A statement to that effect shall be included. Such adjustments shall include, for example, appropriate estimated provisions for bonus and profit sharing arrangements normally determined or settled at year-end. If all such adjustments are of a normal recurring nature, a statement to that effect shall be made; otherwise, there shall be furnished information describing in appropriate detail the nature and amount of any adjustments other than normal recurring adjustments entering into the determination of the results shown.

(c) Periods to be covered. The periods for which interim financial statements are to be provided in registration statements are prescribed elsewhere in this Regulation (see §§ 210.3-01 and 3-02). For filings on Form 10-Q and Form 10-QSB, financial statements shall be provided as set forth below:

(1) An interim balance sheet as of the end of the most recent fiscal quarter and a balance sheet as of the end of the preceding fiscal year shall be provided. The balance sheet as of the end of the preceding fiscal year may be condensed to the same degree as the

interim balance sheet provided. An interim balance sheet as of the end of the corresponding fiscal quarter of the preceding fiscal year need not be provided unless necessary for an understanding of the impact of seasonal fluctuations on the registrant's financial condition.

(2) Interim statements of income shall be provided for the most recent fiscal quarter, for the period between the end of the preceding fiscal year and the end of the most recent fiscal quarter, and for the corresponding periods of the preceding fiscal year. Such statements may also be presented for the cumulative twelve month period ended during the most recent fiscal quarter and for the corresponding preceding period.

(3) Interim statements of cash flows shall be provided for the period between the end of the preceding fiscal year and the end of the most recent fiscal quarter, and for the corresponding period of the preceding fiscal year. Such statements may also be presented for the cumulative twelve month period ended during the most recent fiscal quarter and for the corresponding preceding period.

(4) Registrants engaged in seasonal production and sale of a single-crop agricultural commodity may provide interim statements of income and cash flows for the twelve month period ended during the most recent fiscal quarter and for the corresponding preceding period in lieu of the year-to-date statements specified in (2) and (3) above.

(d) Interim review by independent public accountant. Prior to filing, interim financial statements included in quarterly reports on Form 10-Q (17 CFR 249.308(a)) must be reviewed by an independent public accountant using professional standards and procedures for conducting such reviews, as established by generally accepted auditing standards, as may be modified or supplemented by the Commission. If, in any filing, the company states that interim financial statements have been reviewed by an independent public accountant, a report of the accountant on the review must be filed with the interim financial statements.

(e) Filing of other interim financial information in certain cases. The Commission may, upon the informal written request of the registrant, and where consistent with the protection of investors, permit the omission of any of the interim financial information herein required or the filing in substitution thereof of appropriate information of comparable character. The Commission may also by informal written notice require the filing of other information in addition to, or in substitution for, the interim information herein required in

any case where such information is necessary or appropriate for an adequate presentation of the financial condition of any person for which interim financial information is required, or whose financial information is otherwise necessary for the protection of investors.

[46 FR 12489, Feb. 17, 1981, as amended at 50 FR 25215, June 18, 1985; 50 FR 49533, Dec. 3, 1985; 57 FR 45293, Oct. 1, 1992; 64 FR 73401, Dec. 30, 1999]

## Section C: Amendments Related to FASB Accounting Standards Update 2010-22

*This Accounting Standards Update amends various SEC paragraphs related to Update 2010-22 as described in the instructions below.*

40. The following amendments reflect the deletion of SAB Topic 5.H, “Accounting for Sales of Stock by a Subsidiary,” that was codified in paragraph 505-10-S99-6. Paragraph 505-10-S99-6 was superseded by Accounting Standards Update No. 2010-22, *Accounting for Various Topics*.

41. Supersede paragraphs 505-10-S25-2, 505-10-S45-10, 505-10-S50-4, and 605-40-S25-4 and their related headings, with no link to a transition paragraph, as follows:

### **Equity—Overall**

#### **Recognition**

##### **~~> Sales of Stock by a Subsidiary~~**

~~505-10-S25-2 Paragraph superseded by Accounting Standards Update 2012-03. See paragraph 505-10-S99-6, SAB Topic 5.H, for SEC Staff views on accounting for sales of stock by a subsidiary.~~

#### **Other Presentation Matters**

##### **~~> Accounting for Sales of Stock by a Subsidiary~~**

~~505-10-S45-10 Paragraph superseded by Accounting Standards Update 2012-03. See paragraph 505-10-S99-6, SAB Topic 5.H, Question 6, for SEC Staff views on presentation of gains or losses arising from the issuance of subsidiary stock.~~

## Disclosure

### **> ~~Disclosures Pertaining to Issuance of Subsidiary Stock~~**

~~505-10-S50-4 Paragraph superseded by Accounting Standards Update 2012-03. See paragraph 505-10-S99-6, SAB Topic 5.H, Question 6, for SEC Staff views on disclosures pertaining to issuances of a subsidiary's stock.~~

## Revenue Recognition—Gains and Losses

### Recognition

#### **> ~~Accounting for Sales of Stock by a Subsidiary~~**

~~605-40-S25-4 Paragraph superseded by Accounting Standards Update 2012-03. See paragraph 505-10-S99-6, SAB Topic 5.H, for SEC Staff views on the recognition of gains upon the sale of stock by subsidiary.~~

42. The following amendments reflect the deletion of SAB Topic 5.U, “Gain Recognition on the Sale of a Business or Operating Assets to a Highly Leveraged Entity,” that was codified in paragraph 605-40-S99-1. Paragraph 605-40-S99-1 was superseded by Update 2010-22.

43. Supersede paragraphs 605-40-S25-1, 605-40-S45-1, and 605-40-S50-1 and their related headings, with no link to a transition paragraph, as follows:

## Revenue Recognition—Gains and Losses

### Recognition

#### **> ~~Gain Recognition on the Sale of a Business or Operating Assets to a Highly Leveraged Entity~~**

~~605-40-S25-1 Paragraph superseded by Accounting Standards Update 2012-03. See paragraph 605-40-S99-1, SAB Topic 5.U, for SEC Staff views on gain recognition on the sale of a business or operating assets to a highly leveraged entity.~~

## Other Presentation Matters

#### **> ~~Gain Recognition on the Sale of a Business or Operating Assets to a Highly Leveraged Entity~~**

~~605-40-S45-1 Paragraph superseded by Accounting Standards Update 2012-03. See paragraph 605-40-S99-1, SAB Topic 5.U, for SEC Staff views on presentation of deferred gains related to the sale of a business or operating assets to a highly leveraged entity.~~

## Disclosure

### ~~> Gain Recognition on the Sale of a Business or Operating Assets to a Highly Leveraged Entity~~

~~605-40-S50-1 Paragraph superseded by Accounting Standards Update 2012-03. See paragraph 605-40-S99-1, SAB Topic 5.U, for SEC Staff views on disclosures related to the sale of a business or operating assets to a highly leveraged entity.~~

44. The following amendments reflect the deletion of SAB Topic 2.A.5, “Adjustments to Allowance for Loan Losses in Connection with Business Combinations,” that was codified in paragraph 942-805-S99-1. Paragraph 942-805-S99-1 was superseded by Update 2010-22.

45. Supersede paragraphs 805-10-S55-5, 942-805-S30-1, and 942-805-S55-1 and their related headings, with no link to a transition paragraph, as follows:

## Business Combinations—Overall

### Implementation Guidance and Illustrations

#### ~~> Adjustments to Allowances for Loan Losses in Connection with Business Combinations~~

~~805-10-S55-5 Paragraph superseded by Accounting Standards Update 2012-03. See paragraph 942-805-S99-1, SAB Topic 2.A.5, for SEC Staff views on adjustments to allowances for loan losses in connection with business combinations.~~

## Financial Services—Depository and Lending—Business Combinations

### Initial Measurement

#### ~~> Adjustments to Allowances for Loan Losses in Connection with Business Combinations~~

~~942-805-S30-1 Paragraph superseded by Accounting Standards Update 2012-03. See paragraph 942-805-S99-1, SAB Topic 2.A.5, for SEC Staff views on~~

~~making adjustments to an allowance for loan loss in connection with a business combination.~~

## **Implementation Guidance and Illustrations**

### **~~> Adjustments to Allowance for Loan Losses in Connection with Business Combinations~~**

~~**942-805-S55-1** Paragraph superseded by Accounting Standards Update 2012-03. See paragraph 942-805-S99-1, SAB Topic 2.A.5, for SEC Staff views on making adjustments to an allowance for loan loss in connection with a business combination.~~

46. The following amendments reflect the deletion of SAB Topic 2.A.7, “Loss Contingencies Assumed in a Business Combination,” that was codified in paragraph 805-20-S99-1. Paragraph 805-20-S99-1 was superseded by Update 2010-22.

47. Supersede paragraphs 805-20-S50-1 and 805-20-S55-1 and their related headings, with no link to a transition paragraph, as follows:

### **Business Combination—Identifiable Assets and Liabilities, and Any Noncontrolling Interest**

#### **Disclosure**

#### **~~> Loss Contingencies Assumed in a Business Combination~~**

~~**805-20-S50-1** Paragraph superseded by Accounting Standards Update 2012-03. See paragraph 805-20-S99-1, SAB Topic 2.A.7, for SEC Staff views regarding contingent liabilities assumed in a business combination.~~

## **Implementation Guidance and Illustrations**

### **~~> Loss Contingencies Assumed in a Business Combination~~**

~~**805-20-S55-1** Paragraph superseded by Accounting Standards Update 2012-03. See paragraph 805-20-S99-1, SAB Topic 2.A.7, for SEC Staff Views regarding loss contingencies assumed in a business combination.~~

48. The following amendment reflects the deletion of SAB Topic 2.A.9, “Liabilities Assumed in a Business Combination,” that was codified in paragraph 805-20-S99-2. Paragraph 805-20-S99-2 was superseded by Update 2010-22.

49. Supersede paragraph 805-20-S55-2 and its related heading, with no link to a transition paragraph, as follows:

**Business Combinations—Identifiable Assets and Liabilities, and Any Noncontrolling Interest**

**Implementation Guidance and Illustrations**

**> ~~Liabilities Assumed in a Business Combination~~**

**805-20-S55-2** Paragraph superseded by Accounting Standards Update 2012-03. See paragraph 805-20-S99-2, SAB Topic 2.A.9, for SEC Staff views regarding the accounting for contingencies in a business combination.

Section D: Amendments to Status Sections

50. Amend paragraph 205-10-S00-1 by adding the following items to the table, as follows:

**205-10-S00-1** The following table identifies the changes made to this Subtopic.

Paragraph Number	Action	Accounting Standards Update	Date
205-10-S99-1	Amended	2012-03	08/27/2012
205-10-S99-8	Amended	2012-03	08/27/2012

51. Amend paragraph 205-20-S00-1 as follows:

**205-20-S00-1** ~~No updates have been made to this subtopic.~~ The following table identifies the changes made to this Subtopic.

Paragraph Number	Action	Accounting Standards Update	Date
205-20-S99-1	Amended	2012-03	08/27/2012
205-20-S99-2	Amended	2012-03	08/27/2012

52. Amend paragraph 225-10-S00-1 by adding the following item to the table, as follows:

**225-10-S00-1** The following table identifies the changes made to this Subtopic.

<b>Paragraph Number</b>	<b>Action</b>	<b>Accounting Standards Update</b>	<b>Date</b>
225-10-S99-4	Amended	2012-03	08/27/2012

53. Amend paragraph 235-10-S00-1 by adding the following items to the table, as follows:

**235-10-S00-1** The following table identifies the changes made to this Subtopic.

<b>Paragraph Number</b>	<b>Action</b>	<b>Accounting Standards Update</b>	<b>Date</b>
235-10-S99-1	Amended	2012-03	08/27/2012
235-10-S99-5	Amended	2012-03	08/27/2012

54. Amend paragraph 250-10-S00-1 as follows:

**250-10-S00-1** ~~No updates have been made to this subtopic.~~ The following table identifies the changes made to this Subtopic.

<b>Paragraph Number</b>	<b>Action</b>	<b>Accounting Standards Update</b>	<b>Date</b>
250-10-S99-1 through S99-5	Amended	2012-03	08/27/2012

55. Amend paragraph 260-10-S00-1 by adding the following item to the table, as follows:

**260-10-S00-1** The following table identifies the changes made to this Subtopic.

<b>Paragraph Number</b>	<b>Action</b>	<b>Accounting Standards Update</b>	<b>Date</b>
260-10-S99-1	Amended	2012-03	08/27/2012

56. Amend paragraph 270-10-S00-1 by adding the following item to the table, as follows:

**270-10-S00-1** The following table identifies the changes made to this Subtopic.

<b>Paragraph Number</b>	<b>Action</b>	<b>Accounting Standards Update</b>	<b>Date</b>
270-10-S99-1	Amended	2012-03	08/27/2012

57. Amend paragraph 310-10-S00-1 by adding the following items to the table, as follows:

**310-10-S00-1** The following table identifies the changes made to this Subtopic.

<b>Paragraph Number</b>	<b>Action</b>	<b>Accounting Standards Update</b>	<b>Date</b>
310-10-S99-1	Amended	2012-03	08/27/2012
310-10-S99-4	Amended	2012-03	08/27/2012

58. Amend paragraph 320-10-S00-1 by adding the following item to the table, as follows:

**320-10-S00-1** The following table identifies the changes made to this Subtopic.

<b>Paragraph Number</b>	<b>Action</b>	<b>Accounting Standards Update</b>	<b>Date</b>
320-10-S99-1	Amended	2012-03	08/27/2012

59. Amend paragraph 323-10-S00-1 by adding the following items to the table, as follows:

**323-10-S00-1** The following table identifies the changes made to this Subtopic.

<b>Paragraph Number</b>	<b>Action</b>	<b>Accounting Standards Update</b>	<b>Date</b>
323-10-S99-1	Amended	2012-03	08/27/2012
323-10-S99-2	Amended	2012-03	08/27/2012

60. Amend paragraph 330-10-S00-1 by adding the following items to the table, as follows:

**330-10-S00-1** The following table identifies the changes made to this Subtopic.

<b>Paragraph Number</b>	<b>Action</b>	<b>Accounting Standards Update</b>	<b>Date</b>
330-10-S99-1	Amended	2012-03	08/27/2012
330-10-S99-2	Amended	2012-03	08/27/2012

61. Amend paragraph 340-10-S00-1 by adding the following item to the table, as follows:

**340-10-S00-1** The following table identifies the changes made to this Subtopic.

<b>Paragraph Number</b>	<b>Action</b>	<b>Accounting Standards Update</b>	<b>Date</b>
340-10-S99-2	Amended	2012-03	08/27/2012

62. Amend paragraph 360-10-S00-1 as follows:

**360-10-S00-1** ~~No updates have been made to this subtopic.~~ The following table identifies the changes made to this Subtopic.

<b>Paragraph Number</b>	<b>Action</b>	<b>Accounting Standards Update</b>	<b>Date</b>
360-10-S99-2	Amended	2012-03	08/27/2012

63. Amend paragraph 420-10-S00-1 as follows:

**420-10-S00-1** ~~No updates have been made to this subtopic.~~ The following table identifies the changes made to this Subtopic.

<b>Paragraph Number</b>	<b>Action</b>	<b>Accounting Standards Update</b>	<b>Date</b>
420-10-S99-1	Amended	2012-03	08/27/2012
420-10-S99-2	Amended	2012-03	08/27/2012

64. Amend paragraph 450-20-S00-1 by adding the following item to the table, as follows:

**450-20-S00-1** The following table identifies the changes made to this Subtopic.

<b>Paragraph Number</b>	<b>Action</b>	<b>Accounting Standards Update</b>	<b>Date</b>
450-20-S99-1	Amended	2012-03	08/27/2012

65. Amend paragraph 470-10-S00-1 by adding the following item to the table, as follows:

**470-10-S00-1** The following table identifies the changes made to this Subtopic.

Paragraph Number	Action	Accounting Standards Update	Date
470-10-S99-3	Amended	2012-03	08/27/2012

66. Amend paragraph 480-10-S00-1 by adding the following item to the table, as follows:

**480-10-S00-1** The following table identifies the changes made to this Subtopic.

Paragraph Number	Action	Accounting Standards Update	Date
480-10-S99-2	Amended	2012-03	08/27/2012

67. Amend paragraph 505-10-S00-1 by adding the following items to the table, as follows:

**505-10-S00-1** The following table identifies the changes made to this Subtopic.

Paragraph Number	Action	Accounting Standards Update	Date
505-10-S25-2	Superseded	2012-03	08/27/2012
505-10-S45-10	Superseded	2012-03	08/27/2012
505-10-S50-4	Superseded	2012-03	08/27/2012
505-10-S99-7	Amended	2012-03	08/27/2012

68. Amend paragraph 505-60-S00-1 as follows:

**505-60-S00-1** ~~No updates have been made to this subtopic.~~ The following table identifies the changes made to this Subtopic.

<b>Paragraph Number</b>	<b>Action</b>	<b>Accounting Standards Update</b>	<b>Date</b>
505-60-S99-1	Amended	2012-03	08/27/2012

69. Amend paragraph 605-10-S00-1 by adding the following item to the table, as follows:

**605-10-S00-1** The following table identifies the changes made to this Subtopic.

<b>Paragraph Number</b>	<b>Action</b>	<b>Accounting Standards Update</b>	<b>Date</b>
605-10-S99-1	Amended	2012-03	08/27/2012

70. Amend paragraph 605-15-S00-1 by adding the following item to the table, as follows:

**605-15-S00-1** The following table identifies the changes made to this Subtopic.

<b>Paragraph Number</b>	<b>Action</b>	<b>Accounting Standards Update</b>	<b>Date</b>
605-15-S99-2	Amended	2012-03	08/27/2012

71. Amend paragraph 605-40-S00-1 by adding the following items to the table, as follows:

**605-40-S00-1** The following table identifies the changes made to this Subtopic.

<b>Paragraph Number</b>	<b>Action</b>	<b>Accounting Standards Update</b>	<b>Date</b>
605-40-S25-1	Superseded	2012-03	08/27/2012
605-40-S25-4	Superseded	2012-03	08/27/2012
605-40-S45-1	Superseded	2012-03	08/27/2012
605-40-S50-1	Superseded	2012-03	08/27/2012

72. Amend paragraph 718-10-S00-1 by adding the following item to the table, as follows:

**718-10-S00-1** The following table identifies the changes made to this Subtopic.

<b>Paragraph Number</b>	<b>Action</b>	<b>Accounting Standards Update</b>	<b>Date</b>
718-10-S99-1	Amended	2012-03	08/27/2012

73. Amend paragraph 730-20-S00-1 by adding the following items to the table, as follows:

**730-20-S00-1** The following table identifies the changes made to this Subtopic.

<b>Paragraph Number</b>	<b>Action</b>	<b>Accounting Standards Update</b>	<b>Date</b>
730-20-S99-1	Amended	2012-03	08/27/2012

74. Amend paragraph 805-10-S00-1 by adding the following items to the table, as follows:

**805-10-S00-1** The following table identifies the changes made to this Subtopic.

<b>Paragraph Number</b>	<b>Action</b>	<b>Accounting Standards Update</b>	<b>Date</b>
805-10-S55-5	Superseded	2012-03	08/27/2012
805-10-S99-2	Amended	2012-03	08/27/2012

75. Amend paragraph 805-20-S00-1 by adding the following items to the table, as follows:

**805-20-S00-1** The following table identifies the changes made to this Subtopic.

<b>Paragraph Number</b>	<b>Action</b>	<b>Accounting Standards Update</b>	<b>Date</b>
805-20-S50-1	Superseded	2012-03	08/27/2012
805-20-S55-1	Superseded	2012-03	08/27/2012
805-20-S55-2	Superseded	2012-03	08/27/2012

76. Amend paragraph 805-50-S00-1 by adding the following item to the table, as follows:

**805-50-S00-1** The following table identifies the changes made to this Subtopic.

<b>Paragraph Number</b>	<b>Action</b>	<b>Accounting Standards Update</b>	<b>Date</b>
805-50-S99-1	Amended	2012-03	08/27/2012

77. Amend paragraph 810-10-S00-1 by adding the following item to the table, as follows:

**810-10-S00-1** The following table identifies the changes made to this Subtopic.

<b>Paragraph Number</b>	<b>Action</b>	<b>Accounting Standards Update</b>	<b>Date</b>
810-10-S99-5	Amended	2012-03	08/27/2012

78. Amend paragraph 815-10-S00-1 by adding the following item to the table, as follows:

**815-10-S00-1** The following table identifies the changes made to this Subtopic.

<b>Paragraph Number</b>	<b>Action</b>	<b>Accounting Standards Update</b>	<b>Date</b>
815-10-S99-1	Amended	2012-03	08/27/2012

79. Amend paragraph 845-10-S00-1 as follows:

**845-10-S00-1** ~~No updates have been made to this subtopic.~~ The following table identifies the changes made to this Subtopic.

<b>Paragraph Number</b>	<b>Action</b>	<b>Accounting Standards Update</b>	<b>Date</b>
845-10-S99-1	Amended	2012-03	08/27/2012

80. Amend paragraph 852-20-S00-1 as follows:

**852-20-S00-1** ~~No updates have been made to this subtopic.~~ The following table identifies the changes made to this Subtopic.

<b>Paragraph Number</b>	<b>Action</b>	<b>Accounting Standards Update</b>	<b>Date</b>
852-20-S99-2	Amended	2012-03	08/27/2012

81. Amend paragraph 932-10-S00-1 by adding the following item to the table, as follows:

**932-10-S00-1** The following table identifies the changes made to this Subtopic.

<b>Paragraph Number</b>	<b>Action</b>	<b>Accounting Standards Update</b>	<b>Date</b>
932-10-S99-2	Amended	2012-03	08/27/2012

82. Amend paragraph 932-235-S00-1 as follows:

**932-235-S00-1** ~~No updates have been made to this subtopic.~~ The following table identifies the changes made to this Subtopic.

<b>Paragraph Number</b>	<b>Action</b>	<b>Accounting Standards Update</b>	<b>Date</b>
932-235-S99-1	Amended	2012-03	08/27/2012

83. Amend paragraph 932-360-S00-1 by adding the following item to the table, as follows:

**932-360-S00-1** The following table identifies the changes made to this Subtopic.

<b>Paragraph Number</b>	<b>Action</b>	<b>Accounting Standards Update</b>	<b>Date</b>
932-360-S99-2	Amended	2012-03	08/27/2012

84. Amend paragraph 942-805-S00-1 by adding the following items to the table, as follows:

**942-805-S00-1** The following table identifies the changes made to this Subtopic.

<b>Paragraph Number</b>	<b>Action</b>	<b>Accounting Standards Update</b>	<b>Date</b>
942-805-S30-1	Superseded	2012-03	08/27/2012
942-805-S55-1	Superseded	2012-03	08/27/2012

85. Amend paragraph 942-810-S00-1 as follows:

**942-810-S00-1** ~~No updates have been made to this subtopic.~~ The following table identifies the changes made to this Subtopic.

<b>Paragraph Number</b>	<b>Action</b>	<b>Accounting Standards Update</b>	<b>Date</b>
942-810-S99-1	Amended	2012-03	08/27/2012

86. Amend paragraph 944-20-S00-1 by adding the following item to the table, as follows:

**944-20-S00-1** The following table identifies the changes made to this Subtopic.

<b>Paragraph Number</b>	<b>Action</b>	<b>Accounting Standards Update</b>	<b>Date</b>
944-20-S99-1	Amended	2012-03	08/27/2012

87. Add paragraph 944-40-S00-1 as follows:

**944-40-S00-1** The following table identifies the changes made to this Subtopic.

<b>Paragraph Number</b>	<b>Action</b>	<b>Accounting Standards Update</b>	<b>Date</b>
944-40-S99-1	Amended	2012-03	08/27/2012

## Amendments to the XBRL Taxonomy

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There are no proposed amendments to the XBRL taxonomy as a result of the amendments in this Update.