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No. 2009-03
August 2009

SEC Update

Amendments to Various Topics Containing SEC Staff Accounting Bulletins

An Amendment of the *FASB Accounting Standards Codification*™

Financial Accounting Standards Board
of the Financial Accounting Foundation

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401 MERRITT 7, PO BOX 5116, NORWALK, CONNECTICUT 06856-5116

Securities and Exchange Commission (SEC) Content

SEC Update

Amendments to Various Topics Containing SEC Staff Accounting Bulletins

This Codification Update represents technical corrections to various Topics containing SEC Staff Accounting Bulletins to update cross-references to Codification text.

1. Amend various Staff Accounting Bulletin (SAB) paragraphs in the Codification, with no link to a transition paragraph, as follows:

> > > 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: 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. 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 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 paragraph 24 of Statement 57 [the FASB Codification Glossary: Related Parties].

- Question 2: 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. 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.

> > > 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 Statement 5. A principal stockholder FN38 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.
  - FN38 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 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 FN39 in the entity as compensation for services provided to the entity are share-based payment transactions to be accounted for under this Statement unless the transfer is clearly for a purpose other than compensation for services to the reporting entity. As explained in paragraph 11 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.
- FN39 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 Statement 123R [Topic 718] is not limited to transactions involving stock compensation. Therefore, similar accounting is required in this and other FN40 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.
  - FN40 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 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 Statement 123R, paragraph 11 [paragraph 718-10-15-4] for transactions other than those specifically covered by it. The staff notes, however, that 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. FN41 However, the staff believes that transactions of the type described above differ from the typical related party transactions.
  - FN41 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 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.

> > > 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.

- Accounting for loan losses
  - General: GAAP for recognition of loan losses is provided by Statements 5 [Topic 450] and 114 [Topic 310]. 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] 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]. 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.
    - FN7 Paragraph 8 of Statement 5 [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) 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].

- 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.
        - However, as indicated in the AICPA Audit and Accounting Guide, Banks and Savings Institutions (Audit Guide), "[w]hile different institutions may use different methods, there are certain common elements that should be included in any [loan loss allowance] methodology for it to be effective." FN10 A registrant's loan loss allowance methodology generally should: FN11.
            - FN10 See paragraph 7.05 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] and segment the remainder of the portfolio into groups of loans with similar risk characteristics for evaluation and analysis under Statement 5 [Topic 450];
            - 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. Accounting policies relating to significant financial statement items, including the timing or transactions and the period in which they are 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], 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 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.

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

    - 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 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 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, "[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 7.39 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 provides guidance on "reliability" as a primary quality of accounting 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, item a, in the Audit Guide, a loan loss allowance methodology should "include a detailed and regular analysis of the loan portfolio." Paragraphs 7.06 to 7.13 provide additional information on how creditors 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 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 in the Audit Guide states that "creditors have traditionally identified loans that are to be evaluated for collectibility by dividing the loan portfolio into different segments. Each segment should contain loans with similar characteristics, such as risk classification, past-due status, and type of loan." Paragraph 7.08 provides additional guidance on classifying individual loans and paragraph 7.13 indicates considerations for groups or pools of loans.

- 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]: FN31

    - FN31 See Statement 114, paragraphs 8 through 10 [paragraphs 310-10-35-16 through 35-19] on recognition of impairment and paragraphs 11 through 16 [paragraphs 310-10-35-20 through 35-28] 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], 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]. FN32

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

- For determining and measuring impairment under Statement 5 [Topic 450]: FN33

        -
        - FN33 See Statement 5, paragraphs 8(a) and 8(b) [paragraph 450-20-25-2] on accrual of loss contingencies and paragraphs 22 and 23 [paragraphs 310-10-35-7 through 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.

- Applying a systematic methodology - measuring and documenting loan losses under Statement 114 [Topic 310]
    - a. Measuring and documenting loan losses under Statement 114 [Topic 310] - general.
        - Facts: Approximately one-third of Registrant B's commercial loan portfolio consists of large balance, non-homogeneous loans. Due to their large individual balances, these loans meet the criteria under Registrant B's policies and procedures for individual review for impairment under Statement 114 [Topic 310].
        - Upon review of the large balance loans, Registrant B determines that certain of the loans are impaired as defined by Statement 114 [Topic 310]. FN34
            - FN34 Paragraph 8 of Statement 114 [paragraph 310-10-35-16] 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 the commercial loans reviewed under Statement 114 [Topic 310] 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]?
        - Interpretive Response: For those loans that are reviewed individually under Statement 114 [Topic 310] and considered individually impaired, Registrant B must use one of the methods for measuring impairment that is specified by Statement 114 [Topic 310] (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], it would not be appropriate for Registrant B to choose a measurement method not prescribed by Statement 114 [Topic 310]. 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].
        - 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]. 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 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]. Additionally, as indicated in paragraphs 7.56 to 7.68 of the Audit Guide, the independent accountant, in conducting an audit, may perform a detailed loan file review for selected loans. A registrant's loan files may contain documentation about borrowers' financial resources and cash flows (see paragraph 7.63) or about the collateral securing the loans, if applicable (see paragraphs 7.65 and 7.66).

- FN38 Question #16 in Exhibit D-80A of EITF Topic D-80 [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 in the Audit Guide for additional information about documentation of loan collateral.

- b. Measuring and documenting loan losses under Statement 114 [Topic 310] 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] 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]. 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 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 of the Audit Guide, "[t]he institution's conclusions about the appropriate amount [of loan impairment and the allowance for loan losses] should be well documented."
    - 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 114 [Topic 310] - 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.

- Applying a systematic methodology - measuring and documenting loan losses under Statement 5 [Topic 450]

  - a. Measuring and documenting loan losses under Statement 5 [Topic 450] - general.

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

    - Interpretive Response: For loans evaluated on a group basis under Statement 5 [Topic 450], 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 of the Audit Guide indicates that "[e]ach segment [of the loan portfolio] should contain loans with similar characteristics, such as risk classification, past-due status, and type of loan."

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

    - Based on the segmentation of the loan portfolio, a registrant should estimate the Statement 5 [Topic 450] 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 of the Audit Guide, the loan loss allowance methodology "should be well documented, with clear explanations of the supporting analyses and rationale." Further, as indicated in paragraph 7.14 of the Audit

Guide, "[t]he institution's conclusions about the appropriate amount [of the allowance] should be well documented."

- Facts: After identifying certain loans for evaluation under Statement 114 [Topic 310], 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 ~~310~~ 450] 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 ~~310~~ 450].

- 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 ~~310~~ 450]?

- Interpretive Response: Regardless of the method used to determine loan loss measurements under Statement 5 [Topic ~~310~~ 450], 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]. Also, as indicated in Exhibit D-80A of EITF Topic D-80 [paragraph 310-10-35-4], "[t]he approach for determination of the allowance should be well documented and applied consistently from period to period." (See the overview section of Exhibit D-80A and Question #18.)

- 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].

  - FN51 Registrants should also refer to Interpretation 14 [Topic 450], which provides guidance for situations in which a range of loss can be reasonably estimated but no single amount within the range appears to be a better estimate than any other amount within the range. Also, paragraph 7.14 of the Audit Guide notes the use of "a method that results in a range of estimates for the allowance," except for impairment measurement under Statement 114, which is based on "a single best estimate and not a range of estimates." Paragraph 7.14 also states that "[t]he institution's conclusions about the appropriate amount should be well documented."

- 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 of the Audit Guide, and EITF Topic D-80 [Topic 310].

- 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

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        - FN53 Refer to paragraph 7.13 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 [Topic 450] - 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 of the Audit Guide refers to the documentation, for disclosure purposes, that an entity should include in the notes to the financial statements describing the accounting policies and methodology the entity used to estimate its allowance and related provision for loan losses. As indicated in paragraph 7.33, "[s]uch a description should identify the factors that influenced management's judgment (for example, historical losses and existing economic conditions) and may also include discussion of risk elements relevant to particular categories of financial instruments."
    - 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 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] - 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]. 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 310-10-35-16].
    - Registrant G segments its loan portfolio to estimate loan losses under Statement 5 [Topic 450]. 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] and determined to be impaired as defined by Statement 114 [paragraph 310-10-35-16].
    - In its determination of its loan loss allowance under Statement 5 [Topic 450], 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] states that if a creditor concludes that an individual loan specifically identified for evaluation is not impaired under Statement 114 [Topic 310], that loan may be included in the assessment of the allowance for loan losses under Statement 5 [Topic 450], 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] 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. 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 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] provides guidance as to the analysis to be performed when determining whether a loan that is not individually impaired under Statement 114 [Topic 310] should be included in the assessment of the loan loss allowance under Statement 5 [Topic 450].

  - 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.

- 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

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- 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 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 1.M ~~99~~ and SAS 89 and its 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] 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 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 of the Audit Guide ("the institution's conclusions about the appropriate amount should be well documented") and in FRR 28 ("he 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 - 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 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.

- 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 of the Audit Guide.

> > > > 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 staff believes that Statement 13 [Topic 840] 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]. Accordingly, it would be inappropriate for a department store or other retailer to include in its revenue the sales of the leased or licensed departments. Rather, the department store or other retailer should include the rental income as part of its gross revenue.

- The staff would not object to disclosure in the footnotes to the financial statements of the amount of the lessee's sales from leased departments.

- If the arrangement is not a lease but rather a service arrangement that provides for payment of a fee or commission, the retailer should recognize the fee or commission as revenue when earned. If the retailer assumes the risk of bad debts associated with the lessee's merchandise sales, the retailer generally should present bad debt expense in accordance with Rule 5-03(b)(5) of Regulation S-X.

- FN1 Statement 13, paragraph 1 [the FASB Codification Glossary: Lease] defines a lease as "the right to use property, plant, or equipment (land or depreciable assets or both) usually for a stated period of time."

> > > SAB Topic 10.F, Presentation of Liabilities for Environmental Costs

980-410-S99-1 The following is the text of SAB Topic 10.F, Presentation of Liabilities for Environmental Costs.

- Facts: A public utility company determines that it is obligated to pay material amounts as a result of an environmental liability. These amounts may relate to, for example, damages attributed to clean-up of hazardous wastes, reclamation costs, fines, and litigation costs.

- Question 1: May a rate-regulated enterprise present on its balance sheet the amount of its estimated liability for environmental costs net of probable future revenue resulting from the inclusion of such costs in allowable costs for rate-making purposes?

- Interpretive Response: No. Statement 71 [paragraph 980-340-25-1] specifies the conditions under which rate actions of a regulator can provide reasonable assurance of the existence of an asset. The staff believes that environmental costs meeting the criteria of paragraph 9 FN6 of Statement 71 [paragraph 980-340-25-1] should be presented on the balance sheet as an asset and should not be offset against the liability. Contingent recoveries through rates that do not meet the criteria of paragraph 9 [paragraph 980-340-25-1] should not be recognized either as an asset or as a reduction of the probable liability.

    - FN6 Paragraph 9 of Statement 71 [paragraph 980-340-25-1] requires a rate-regulated enterprise to capitalize all or part of an incurred cost that would otherwise be charged to expense if it is probable that future revenue will be provided to recover the previously incurred cost from inclusion of the costs in allowable costs for rate-making purposes.

- Question 2: May a rate-regulated enterprise delay recognition of a probable and estimable liability for environmental costs which it has incurred at the date of the latest balance sheet until the regulator's deliberations have proceeded to a point enabling management to determine whether this cost is likely to be included in allowable costs for rate-making purposes?

- Interpretive Response: No. Statement 5 [paragraph 450-20-25-2] states that an estimated loss from a loss contingency shall be accrued by a charge to income if it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. FN7 The staff believes that actions of a regulator can affect whether an incurred cost is capitalized or expensed pursuant to Statement 71 [paragraph 980-340-25-1], but the regulator's actions cannot affect the timing of the recognition of the liability.

    - FN7 Registrants also should apply the guidance of SOP 96-1[Section 410-30-25] in determining the appropriate recognition of environmental remediation costs.

> > > SAB Topic 12.A, Accounting Series Release 257—Requirements for Financial Accounting and Reporting Practices for Oil and Gas Producing Activities

932-360-S99-1 The following is the text of SAB Topic 12.A, Accounting Series Release 257—Requirements for Financial Accounting and Reporting Practices for Oil and Gas Producing Activities.

- 1. Estimates of Quantities of Proved Reserves

- Facts: Rule 4-10 contains definitions of proved reserves, proved developed reserves, and proved undeveloped reserves to be used in determining quantities of oil and gas reserves to be reported in filings with the Commission.

- Question 1: The definition of proved reserves states that reservoirs are considered proved if "economic producibility is supported by either actual production or conclusive formation test." May oil and gas reserves be considered proved if economic producibility is supported only by core analyses and/or electric or other log interpretations?

- Interpretive Response: Economic producibility of estimated proved reserves can be supported to the satisfaction of the Office of Engineering if geological and engineering data demonstrate with reasonable certainty that those reserves can be recovered in future years under existing economic and operating conditions. The relative importance of the many pieces of geological and engineering data which should be evaluated when classifying reserves cannot be identified in advance. In certain instances, proved reserves may be assigned to reservoirs on the basis of a combination of electrical and other type logs and core analyses which indicate the reservoirs are analogous to similar reservoirs in the same field which are producing or have demonstrated the ability to produce on a formation test.

- Question 2: In determining whether "proved undeveloped reserves" encompass acreage on which fluid injection (or other improved recovery technique) is contemplated, is it appropriate to distinguish between (i) fluid injection used for pressure maintenance during the early life of a field and (ii) fluid injection used to effect secondary recovery when a field is in the late stages of depletion? The definition in Rule 4-10(a)(4) does not make this distinction between pressure maintenance activity and fluid injection undertaken for purposes of secondary recovery.

- Interpretive Response: The Office of Engineering believes that the distinction identified in the above question may be appropriate in a few limited circumstances, such as in the case of certain fields in the North Sea. The staff will review estimates of proved reserves attributable to fluid injection in the light of the strength of the evidence presented by the registrant in support of a contention that enhanced recovery will be achieved.

- Question 3: What volumes of natural gas liquids should be reported as net reserves, that portion recovered in a gas processing plant and allocated to the leasehold interest or the total recovered by a plant from net interest gas?

- Interpretive Response: Companies should report reserves of natural gas liquids which are net to their leasehold interests, i.e., that portion recovered in a processing plant and allocated to the leasehold interest. It may be appropriate in the case of natural gas liquids not clearly attributable to leasehold interests ownership to follow instructions to Item 3 of Securities Act Industry Guide 2 and report such reserves separately and describe the nature of the ownership.

- Question 4: What pressure base should be used for reporting gas and production, 14.73 psia or the pressure base specified by the state?

- Interpretive Response: The reporting instructions to the Department of Energy's Form EIA-28 specify that natural gas reserves are to be reported at 14.73 psia and 60 degrees F. There is no pressure base specified in Regulation S-X or S-K. At the present time the staff will not object to natural gas reserves and production data calculated at other pressure bases, if such other pressure bases are identified in the filing.

- 2. Estimates of Future Net Revenues

- Facts: Paragraphs 30-34 of Statement 69 [paragraphs 932-235-50-29 through 50-36] require the disclosure of the standardized measure of discounted future net cash flows from production of proved oil and gas reserves, computed by applying year-end prices of oil and gas (with consideration of price changes only to the extent provided by contractual arrangements) to estimated future production as of the latest balance sheet date, less estimated future expenditures (based on current costs) of developing and producing the proved reserves, and assuming continuation of existing economic conditions.

- Question 1: For purposes of determining reserves and estimated future net revenues, what price should be used for gas which will be produced after an existing contract expires or after the redetermination date in a contract?

- Interpretive Response: The price to be used for gas which will be produced after a contract expires or has a redetermination is the current market price at the end of the fiscal year for that category of gas. This price may be increased thereafter only for additional fixed and determinable escalations, as appropriate, for that category of gas. A fixed and determinable escalation is one which is specified in amount and is not based on future events such as rates of inflation.

- Question 2: What price should be applied to gas which at the end of a fiscal year is not yet subject to a gas sales contract?
- Interpretive Response: The price to be used is the current market price for similarly situated gas at the end of the fiscal year provided the company can reasonably expect to sell the gas at the prevailing market price.
- Question 3: To what extent should price increases announced by OPEC or by certain government agencies not yet effective at the date of the reserve report be considered in determining current prices?
- Interpretive Response: Current prices should not reflect price increases announced but not yet effective at the date of the reserve valuation, i.e., the end of the fiscal year.
- 3. Disclosure of Reserve Information
- b. Unproved properties.
- Facts: Disclosures of reserve information are based on estimated quantities of proved reserves of oil and gas. Regulation S-K prohibits disclosure of estimated quantities of probable or possible reserves of oil and gas and any estimated value thereof in any document publicly filed with the Commission.
- Question: What types of disclosures will be permitted by registrants who wish to indicate that some of their properties have value other than that attributable to proved reserves?
- Interpretive Response: The Office of Engineering has, for the past several years, suggested to registrants the following form of disclosure for undeveloped lease acreage:
- "In addition to proved reserves, the estimated (or appraised) value of leases or parts of leases to which proved reserves cannot be attributable is $xxx."
- The registrant should describe the basis on which the estimate was made. For example, such estimated values are often based on the market demand for leasehold acreage which, in turn, is based on a number of qualitative factors such as proximity to production. If the disclosed amount is based on an appraisal, the person making the appraisal should be named.

> > > 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.

Assumptions:			
Capitalized Costs of Oil and Gas Assets			$ 500,000
Accumulated DD&A			(100,000)
Book basis of oil and gas assets			400,000
Related deferred income taxes			35,000
Net book basis to be recovered			$ 365,000
NOL carryforward *			20,000
Foreign tax credit carryforward *			1,000
ITC-Carryforward *		$ 2,000	
Present value of ITC relating to future development costs		1,500	$ 3,500
Estimated preference (minimum) tax on percentage depletion in excess of cost depletion			$ 500
Tax basis of oil and gas assets			$ 270,000
Present value of statutory depletion attributable to future deductions			$ 10,000
Statutory tax rate (percent)			46%
Present value of future net revenues from proved oil and gas reserves			$ 272,000
Cost of properties not being amortized			$ 55,000
Lower of cost or estimated fair value of unproved properties included in costs being amortized			$ 49,000
CALCULATION			
Present value of future net revenue			$ 272,000
Cost of properties not being amortized			55,000
Lower of cost or estimated fair value of unproved properties included in costs being amortized			49,000
Tax Effects:			
Total of above items			$ 376,000
Less: Tax basis of properties	(270,000)		
Statutory depletion	(10,000)		
NOL carryforward	(20,000)	(300,000)	
Future taxable income		76,000	
Tax rate (percent)		x 46%	
Tax payable at statutory rate		(34,960)	
ITC		3,500	
Foreign tax credit carryforward		1,000	
Estimated preference tax		(500)	
Total tax effects			(30,960)
Cost Center Ceiling			$ 345,040
Less: Net book basis			365,000
REQUIRED WRITE-OFF, net of tax **			$ (19,960)

* All carryforward amounts in this example represent amounts which are available for tax purposes and which related to oil and gas operations.

** For accounting purposes, the gross write-off should be recorded to adjust both the oil and gas properties account and the related deferred income taxes.

- 2. Exclusion of Costs From Amortization
- Facts: Rule 4-10(c)(3)(ii) indicates that the costs of acquiring and evaluating unproved properties may be excluded from capitalized costs to be amortized if the costs are unusually significant in relation to aggregate costs to be amortized. Costs of major development projects may also be incurred prior to ascertaining the quantities of proved reserves attributable to such properties.
- Question: At what point should amortization of previously excluded costs commence-when proved reserves have been established or when those reserves become marketable? For instance, a determination of proved reserves may be made before completion of an extraction plant necessary to process sour crude or a pipeline necessary to market the reserves. May the costs continue to be excluded from amortization until the plant or pipeline is in service?
- Interpretive Response: No. The proved reserves and the costs allocable to such reserves should be transferred into the amortization base on an ongoing (well-by-well or property-by-property) basis as the project is evaluated and proved reserves are established.
- Once the determination of proved reserves has been made, there is no justification for continued exclusion from the full cost pool, regardless of whether other factors prevent immediate marketing. Moreover, at the same time that the costs are transferred into the amortization base, it is also necessary in accordance with Interpretation 33 and Statement 34 [Subtopics 932-235 and 835-20] to terminate capitalization of interest on such properties.
- In this regard, registrants are reminded of their responsibilities not to delay recognizing reserves as proved once they have met the engineering standards.
- 3. Full Cost Ceiling Limitation
- a. Exemptions for purchased properties.
- Facts: During 20x1, a registrant purchases proved oil and gas reserves in place ("the purchased reserves") in an arm's length transaction for the sum of $9.8 million. Primarily because the registrant expects oil and gas prices to escalate, it paid $1.2 million more for the purchased reserves than the "Present Value of Estimated Future Net Revenues" computed as defined in Rule 4-10(c)(4)(i)(A) of Regulation S-X. An analysis of the registrant's full cost center in which the purchased reserves are located at December 31, 20x1 is as follows:

(Amounts in 1,000)

	Total	Purchased Reserves	Other Proved Properties	Unproved Properties
Present value of estimated future net revenues	$ 14,100	8,600	5,500	-
Cost, net of amortization	$ 16,300	9,800	5,500	1,000
Related deferred taxes	$ 2,300	-	2,000	300
Income tax effects related to properties	$ 2,500	-	2,500	-

Comparison of capitalized costs with limitation on capitalized costs at December 31, 20x1:	Including Purchased Reserves	Excluding Purchased Reserves
Capitalized costs, net of amortization	$ 16,300	$ 6,500
Related deferred taxes	(2,300)	(2,300)
Net book cost	14,000	4,200
Present value of estimated future net revenues	14,100	$ 5,500
Lower of cost or market of unproved properties	1,000	1,000
Income tax effects related to properties	(2,500)	(2,500)
Limitation on capitalized costs	12,600	4,000
Excess of capitalized costs over limitation on Capitalized costs, net of tax	$ 1,400	$ 200

* For accounting purposes, the gross write-off should be recorded to adjust both the oil and gas properties account and the related deferred income taxes

- Question: Is it necessary for the registrant to write down the carrying value of its full cost center at December 31, 20x1 by $1,400,000?
- Interpretive Response: Although the net carrying value of the full cost center exceeds the cost center's limitation on capitalized costs, the text of ASR 258 provides that a registrant may request an exemption from the rule if as a result of a major purchase of proved properties, a write down would be required even though the registrant believes the fair value of the properties in a cost center clearly exceeds the unamortized costs.
- Therefore, to the extent that the excess carrying value relates to the purchased reserves, the registrant may seek a temporary waiver of the full-cost ceiling limitation from the staff of the Commission. Registrants requesting a waiver should be prepared to demonstrate that the additional value exists beyond reasonable doubt.
- To the extent that the excess costs relate to properties other than the purchased reserves, however, a write-off should be recorded in the current period. In order to determine the portion of the total excess carrying value which is attributable to properties other than the purchased reserves, it is necessary to perform the ceiling computation on a "with and without" basis as shown in the example above. Thus in this case, the registrant must record a write-down of $200,000 applicable to other reserves. An additional $1,200,000 write-down would be necessary unless a waiver were obtained.
- b. Use of cash flow hedges in the computation of the limitation on capitalized costs.
- Facts: Rule 4-10(c)(4) of Regulation S-X provides, in pertinent part, that capitalized costs, net of accumulated depreciation and amortization, and deferred income taxes, should not exceed an amount equal to the sum of [components that include] the present value of estimated future net revenues computed by applying current prices of

oil and gas reserves (with consideration of price changes only to the extent provided by contractual arrangements) to estimated future production of proved oil and gas reserves as of the date of the latest balance sheet presented.

- As of the reported balance sheet date, capitalized costs of an oil and gas producing company exceed the full cost limitation calculated under the above described rule based on current spot market prices for oil and natural gas. However, prior to the balance sheet date, the company enters into certain hedging arrangements for a portion of its future natural gas and oil production, thereby enabling the company to receive future cash flows that are higher than the estimated future cash flows indicated by use of the spot market price as of the reported balance sheet date. These arrangements qualify as cash flow hedges under the provisions of Statement 133 [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 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 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.

- Nonetheless, the staff expects that oil and gas producing companies subject to the full cost rules will clearly indicate the effects of using cash flow hedges in calculating ceiling limitations within their financial statement footnotes. The staff further expects that disclosures will indicate the portion of future oil and gas production being hedged. The dollar amount that would have been charged to income had the effects of the cash flow hedges not been considered in calculating the ceiling limitation also should be disclosed.

- The use of hedge-adjusted prices should be consistently applied in all reporting periods, including periods in which the hedge-adjusted price is less than the current spot market price. Oil and gas producers whose computation of the ceiling limitation includes hedge-adjusted prices because of the use of cash flow hedges also should consider the disclosure requirements under the SOP 94-6 [Section 275-10-50]. 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 on properties owned at year-end, or (2) price increases become known which were not fixed and determinable at year-end. The present value of future net revenues from the additional reserves or from the increased prices is sufficiently large that if the full cost ceiling limitation were recomputed giving effect to those factors as of year-end, the ceiling would more than cover the costs. It is necessary to record a write down?

- Interpretive Response: No. In these cases, the proving up of additional reserves on properties owned at year-end or the increase in prices indicates that the capitalized costs were not in fact impaired at year-end. However, for purposes of the revised computation of the "ceiling," the net book costs capitalized as of year-end should be increased by the amount of any additional costs incurred subsequent to year-end to prove the additional reserves or by any related costs previously excluded from amortization.

- While the fact pattern described herein relates to annual periods, the guidance on the effects of subsequent events applies equally to interim period calculations of the ceiling limitation. However, the staff cautions registrants that the process of considering subsequent price changes in the determination of whether a ceiling write-down is called for should be similar to the consideration given to other subsequent events under the auditing literature. The staff expects that the date selected for the ceiling recomputation will be consistent from period to period, and bear a logical relationship to the filing date of the affected financial statements. For example, it would seem logical that an oil and gas producing company would consistently make whatever recalculations are necessary at the date the auditors are completing their interim reviews.

- The registrant's financial statements should disclose that capitalized costs exceeded the limitation thereon at year-end and should explain why the excess was not charged against earnings. In addition, the registrant's supplemental disclosures of estimated proved reserve quantities and related future net revenues and costs should not give effect to the reserves proved up or the cost incurred after year-end or to the price increases occurring after year-end. However, such quantities and amounts may be disclosed separately, with appropriate explanations.

- Registrants should be aware that oil and gas reserves related to properties acquired after year-end would not justify avoiding a write-off indicated as of year-end. Similarly, the effects of cash flow hedging arrangements entered into after year-end cannot be factored into the calculation of the ceiling limitation at year-end. Such acquisitions and financial arrangements do not confirm situations existing at year-end.

- 4. Interaction of 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 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 Statement 143 [Subtopic 410-20], a company must recognize a liability for an asset retirement obligation 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 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 1: 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: 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. FN2, FN3

    - FN2 If an obligation for expected asset retirement costs has not been accrued under 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.

    - FN3 This approach is consistent with the guidance in paragraph 12 of Statement 143 [paragraphs 360-10-35-18 through 35-19] on testing for impairment under 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 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; FN4 (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." Statement 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.

    - FN4 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: 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.

- c. 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.

> > > 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, 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]; and Opinion 10, paragraph 12 [paragraph 605-10-25-3]. 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]. 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)]; SOP 97-2, paragraph 8 [paragraph 985-605-25-3]. SOP 97-2 [Subtopic 985-605] 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] 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] 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] 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. See also Concepts Statement 5, paragraph 84(g) and SOP 97-2, paragraph 8 [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] 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)].
        - (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)]. 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 Statement 48, paragraph 6(c).
            - FN11 Statement 48, paragraph 6(c) [paragraph 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)].
        - (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)].
    - 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). Paragraph 5(a) [paragraph 470-40-15-2(a)] provides examples of circumstances that meet this requirement. As discussed further therein, this condition is present if (a) a resale price guarantee exists, (b) the seller has an option to purchase the product, the economic effect of which compels the seller to purchase the product, or (c) the buyer has an option whereby it can require.
            - FN15 Statement 49, paragraph 5(b) [paragraph 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 EITF Issue 95-1 [paragraphs 840-10-55-12 through 55-25] 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].
- 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). Also see Concepts Statement 5, paragraph 84(a). and SOP 97-2, paragraph 22 [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 21 [Subtopic 835-30] pertaining to the need for discounting the related receivable, is applicable. Opinion 21, paragraph 3(a) [paragraph 835-30-15-3(a)], indicates that the requirements of that Opinion to record receivables at a discounted value are not intended to apply to "receivables and payables arising from transactions with customers or suppliers in the normal course of business which are due in customary trade terms not exceeding approximately one year" (emphasis added).

  - 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].

- 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]. 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].
    - 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]. Statement 48 [Subtopic 605-15] 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. FN25That 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].
        - FN25 Statement 48, paragraph 6(f) [paragraph 605-15-25-1(f)].
        - FN26 Statement 48, paragraphs 8(c) and 8(d) [paragraph 605-15-25-3(c) and (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]. 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)].

        - FN28 Statement 5, paragraph 25 [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 EITF Issue 00-21 [Subtopic 605-25]. 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] 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]. 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]. 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 EITF Issue 00-21 [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].
- 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] 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)].
- 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 Concepts Statement 5, paragraph 83(a) and Statement 48, paragraph 6(b) [paragraph 605-15-25-1(b)].
- 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] 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], 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] 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]).

- 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]).

- 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] and that this arrangement qualifies as a single unit of accounting under EITF Issue 00-21 [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]?

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

- The staff believes that the incremental direct costs (Statement 91 provides an analogous definition) incurred related to the acquisition or origination of a customer contract 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] or paragraph 5 of Statement 91 [paragraph 310-20-35-2]. 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 includes a definition of incremental direct costs in its glossary. Paragraph 6 of Statement 91 [Section 310-20-25] 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] 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]." 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] or Technical Bulletin 90-1 [paragraph 605-25-25-4]. 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].
- 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]?
- 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]) 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 licenser to incur costs in the defense and maintenance of the patent, that obligation does not involve an additional deliverable to the customer. Defending the patent is generally consistent with the seller's representation in the license that such patent is legal and valid. Therefore, the staff would not consider a clause like this to represent an additional deliverable in the arrangement. FN45
    - FN45 Note, however, the staff believes that this obligation qualifies as a guarantee within the scope of FIN 45 [Subtopic 460-10], 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]. FN48
    - FN46 SOP 97-2, paragraph 31 [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]) generally is not fixed or determinable until the future event occurs. The revenue from such transactions should not be recognized in earnings until the sales price or fee becomes fixed or determinable. Moreover, revenue should not be recognized in earnings by assessing the probability that significant, but unfulfilled, terms of a contract will be fulfilled at some point in the future. Accordingly, the revenue from such transactions should not be recognized in earnings prior to the refund privileges expiring. The amounts received from customers or subscribers (i. e., the $35 fee mentioned above) should be credited to a monetary liability account such as "customers' refundable fees.".

- The staff believes that if a customer has the unilateral right to receive both (1) the seller's substantial performance under an arrangement (e. g., providing services or delivering product) and (2) a cash refund of prepaid fees, then the prepaid fees should be accounted for as a monetary liability. In consideration of whether the monetary liability can be derecognized, Statement 140 provides that liabilities may be derecognized only if (1) the debtor pays the creditor and is relieved of its obligation for the liability (paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities) or (2) the debtor is legally released from being the primary obligor under the liability. 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].

- 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] 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]. 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] 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].

- The staff believes that, because service arrangements are specifically excluded from the scope of Statement 48 [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]. 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] 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] and that practice did not change when Statement 140 [Subtopic 405-20] 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] 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.".

  - 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.

- 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] 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].

- 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]. 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] 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 605-15] for service transactions subject to customer cancellation privileges other than those specifically addressed in the previous question?

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

- a leasing broker whose commission from the lessor upon a commercial tenant's signing of a lease agreement is refundable (or in some cases, is not due) under lessor cancellation privileges if the tenant fails to move into the leased premises by a specified date.
- a talent agent whose fee receivable from its principal (i. e., a celebrity) for arranging a celebrity endorsement for a five-year term is cancelable by the celebrity if the celebrity breaches the endorsement contract with its customer.
- an insurance agent whose commission received from the insurer upon selling an insurance policy is refundable in whole for the 30-day period that state law permits the consumer to repudiate the contract and then refundable on a declining pro rata basis until the consumer has made six monthly payments.
- In the first two of these cases, the staff advised the registrants that the portion of revenue subject to customer cancellation and refund must be deferred until no longer subject to that contingency because the registrants did not have an ability to make reliable estimates of customer cancellations due to the lack of a large pool of homogeneous transactions. In the case of the insurance agent, however, the particular registrant demonstrated that it had a sufficient history of homogeneous transactions with the same characteristics from which to reliably estimate contract cancellations and satisfy all the criteria specified in the previous question. Accordingly, the staff did not object to that registrant's policy of recognizing its sales commission as revenue when its performance was complete, with an appropriate allowance for estimated cancellations.
- Question 3.
- Question: Must a registrant analogize to Statement 48 [Subtopic 605-15], or may it choose to defer all revenue until the refund period lapses as suggested by Statement 140 [Subtopic 860-10] even if the criteria above for analogy to Statement 48 [Subtopic 605-15] are met?
- Interpretive Response: The analogy to Statement 48 [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] method to the Statement 140 [Subtopic 860-10] method of accounting for these refundable fees? May a registrant change from the Statement 140 [Subtopic 860-10] method to the Statement 48 [Subtopic 605-15] method?
- Interpretive Response: The staff believes that Statement 140 [Subtopic 860-10] 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] method to the Statement 140 [Subtopic 860-10] method. However, if a registrant had previously chosen the Statement 140 [Subtopic 860-10] method, the staff would object to a change to the Statement 48 [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] type accounting is appropriate?
- Interpretive Response: Statement 48 [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], 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] 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 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], 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].

- 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]?

- Interpretive Response: No. "Reliability" of financial information is one of the qualities of accounting information discussed in Concepts Statement 2. The staff's expectation that estimates be reliable does not change the existing requirement of Statement 48 [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]?
- Interpretive Response: The specific guidance above does not apply to transactions within the scope of Statement 48 [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].
- 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]?
- 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] 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] 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].
    - FN60 Statement 48, paragraph 6(f) [paragraph 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].

- Statement 13 paragraph 19(b) [paragraph 840-20-25-2(b)] states that lessors should account for operating leases as follows: "Rent shall be reported in income over the lease term as it becomes receivable according to the provisions of the lease. However, if the rentals vary from a straight-line basis, the income shall be recognized on a straight-line basis unless another systematic and rational basis is more representative of the time pattern in which use benefit from the leased property is diminished, in which case that basis shall be used."

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

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

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

- The example provided in Statement 29 [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] 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] 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]. Paragraph 12 [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] 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).
- 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 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].

- 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). 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 [~~Topic~~ 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].

> > > 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] 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] 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 1.

  - FN2 Statement 123R, page iv.

- Statement 123R [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] replaces Statement 123 and supersedes Opinion 25. Statement 123, as originally issued in 1995, 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 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 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, the modification of employee share options prior to adoption of Statement 123R and disclosures in MD&A subsequent to adoption of Statement 123R.
    - FN3 Defined in Statement 123R, Appendix E.
- 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, and the interpretive guidance provided by this SAB, particularly during the period of the Statements initial implementation. Thus, throughout this SAB the use of the terms reasonable and reasonably is not meant to imply a single conclusion or methodology, but to encompass the full range of potential conduct, conclusions or methodologies upon which an issuer may reasonably base its valuation decisions. Different conduct, conclusions or methodologies by different issuers in a given situation does not of itself raise an inference that any of those issuers is acting unreasonably. While the zone of reasonable conduct is not unlimited, the staff expects that it will be rare when there is only one acceptable choice in estimating the fair value of share-based payment arrangements under the provisions of Statement 123R [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]. Over time, as issuers and accountants gain more experience in applying Statement 123R [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]?
- Interpretive Response: Only certain aspects of the accounting for share-based payment transactions with nonemployees are explicitly addressed by Statement 123R [Topic 718]. Statement 123R [Topic 718] explicitly:
- Establishes fair value as the measurement objective in accounting for all share-based payments; FN4 and.
    - FN4 Statement 123R, paragraph 7 [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] does not supersede any of the authoritative literature that specifically addresses accounting for share-based payments with nonemployees. For example, Statement 123R [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].
    - FN6 Statement 123R, paragraph 8.
- 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] 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] 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] 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] 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] 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] 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.

  - 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.

  - FN10 For purposes of this staff accounting bulletin, the phrase share options is used to refer to share options or similar instruments.

  - FN11 Statement 123R, paragraph 23 [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] 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)].

  - 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]. 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)], 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 as described in Statement 123R, paragraph B251.

- FN13 Statement 123R, footnote 103 [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] 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]. 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] 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] 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].

    - FN15 Statement 123R, paragraph 37 [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 as described in 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]? FN18

    - FN18 Statement 123R disclosure requirements are described in paragraphs 64, 65, A240, A241 and A242 [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] 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, 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 Guidance Regarding Managements Discussion and Analysis of Financial Condition and Results of Operations.

    - FN20 SEC Release No. FR-60, Cautionary Advice Regarding Disclosure About Critical Accounting Policies.

    - FN21 SEC Release No. FR-72, Commission Guidance Regarding Managements Discussion and Analysis of Financial Condition and Results of Operations.

- SAB Topic 14.C, Valuation Methods

- Statement 123R, paragraph 16 [paragraph 718-10-30-6], 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 Statement 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 123R. FN23

    - FN22 Statement 123R, paragraph A7 [paragraph 718-10-55-10].

    - FN23 Statement 123R, paragraph A8 [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] 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], states The fair value of those instruments at a single point in time is not a forecast of what the estimated fair value of those instruments may be in the future.

- Question 2: In order to meet the fair value measurement objective in Statement 123R [Topic 718], are certain valuation techniques preferred over others?

- Interpretive Response: Statement 123R, paragraph A14 [paragraph 718-10-55-17], clarifies that the Statement does not specify a preference for a particular valuation technique or model. As stated in Statement 123R, paragraph A8 [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], (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].

- 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 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.
- 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.
    - FN28 Statement 123R, paragraph A23 [paragraph 718-10-55-27].
    - FN29 See generally Statement 123R, paragraph 64c [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] 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].
- 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] and in sections (1) and (2) below.
- 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].
- 1. Expected Volatility

- Statement 123R, paragraph A31 [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.

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

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

- Interpretive Response: Statement 123R [Topic 718] does not specify a particular method of estimating expected volatility. However, the Statement 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] 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].

  - FN33 Statement 123R, paragraph A32 [paragraph 718-10-55-37].

  - FN34 Statement 123R, paragraph A34 [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].

- 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)], 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)], 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)], 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], 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], 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].

- 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)].

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

  - 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] 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] are discussed in Questions 2 and 3 above. The objective of estimating volatility, as stated in Statement 123R [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], 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].

  - FN52 Statement 123R, paragraph B86 [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], 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], 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]. 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], prescribes the minimum information needed to achieve the 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]. 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].

- FN58 Statement 123R, paragraph A240(e)(2)(b) [paragraph 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, 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] 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].

    - FN60 Statement 123R, paragraph A22 [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 718-10-55-51].

    - FN63 Statement 123R, paragraph A22 [paragraph 718-10-55-51].

- 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]. 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].

- 2. Expected Term

- Statement 123R, paragraph A26 [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 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] 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)].

- 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]. 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], 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], 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 exercise and valuation of executive stock options, Journal of Financial Economics, May 1998, pp.127-158; C. Marquardt, The Cost of Employee Stock Option Grants: An Empirical Analysis, Journal of Accounting Research, September 2002, p. 1191-1217); and J. Bettis, J. Bizjak and M. Lemmon, Exercise behavior, valuation, and the incentive effect of employee stock options, Journal of Financial Economics, forthcoming, 2005.

- 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] 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], 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].

- 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)].
- Question 4: Statement 123R, paragraph A30 [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, in: J. Carpenter and D. Yermack, eds., Executive Compensation and Shareholder Value: Theory and Evidence (Kluwer, Boston, MA, 1999), pp. 115-142. See also S. Huddart and M. Lang, Employee stock option exercises: An empirical analysis, Journal of Accounting and Economics, 1996, pp. 5-43.
- 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] 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 718-10-55-13].
    - 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] 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 A29 [paragraph 718-10-55-32], states expected term might be estimated in some other manner, taking into account whatever relevant and supportable information is available, including industry averages and other pertinent evidence such as published academic research. For example, data about exercise patterns of employees in similar industries and/or situations as the company's might be used. While such comparative

information may not be widely available at present, the staff understands that various parties, including actuaries, valuation professionals and others are gathering such data.

- FN74 Statement 123R, paragraph A27 [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: expected term = ((vesting term + original contractual term) / 2). Assuming a ten year original contractual term and graded vesting over four years (25% of the options in each grant vest annually) for the share options in the fact set described above, the resultant expected term would be 6.25 years. FN77
  - FN77 Calculated as [[[1 year vesting term (for the first 25% vested) plus 2 year vesting term (for the second 25% vested) plus 3 year vesting term (for the third 25% vested) plus 4 year vesting term (for the last 25% vested)] divided by 4 total years of vesting] plus 10 year contractual life] divided by 2; that is, (((1+2+3+4)/4) + 10) /2 = 6.25 years.
- 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 exercise and valuation of executive stock options, Journal of Financial Economics, 1998, pp.127-158 studies a sample of 40 NYSE and AMEX firms over the period 1979-1994 with share option terms reasonably consistent to the terms presented in the fact set and example. The mean time to exercise after grant was 5.83 years and the median was 6.08 years. The mean time to exercise is shorter than expected term since the study's sample included only exercised options. Other research on executive options includes (but is not limited to) J. Carr Bettis; John M. Bizjak; and Michael L. Lemmon, Exercise behavior, valuation, and the incentive effects of employee stock options, forthcoming in the Journal of Financial Economics. One of the few studies on nonexecutive employee options the staff is aware of is S. Huddart, Patterns of stock option exercise in the United States, in: J. Carpenter and D. Yermack, eds., Executive Compensation and Shareholder Value: Theory and Evidence (Kluwer, Boston, MA, 1999), pp. 115-142.

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

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

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

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

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

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

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

- SAB Topic 14.E, Statement 123R [Topic 718] 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] 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 Preferred Stocks, FN81 (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].

    - 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].

- 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 option, but only after six months from the date of share issuance (as defined in

Statement 123R). Company F has determined that the shares (or share options) would be classified as equity instruments under the guidance of Statement 123R [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], 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]?
    - FN83 Statement 123R, paragraph A231 [paragraph 718-10-35-13], states that an instrument ceases to be subject to Statement 123R when the rights conveyed by the instrument to the holder are no longer dependent on the holder being an employee of the entity (that is, no longer dependent on providing service).
- 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] result in the need to present certain amounts outside of permanent equity (also referred to as being presented in temporary equity) in accordance with ASR 268 and related guidance. 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], would otherwise require the assumption of net cash settlement. See Statement 123R, footnote 152 to paragraph B121 [Section 815-40-25], which states, in part: Issue 00-19 specifies that events or actions necessary to deliver registered shares are not controlled by a company and, therefore, except under limited circumstances, such provisions would require a company to assume that the contract would be net-cash settled. 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 718-10-25-15(a)].
- When an instrument ceases to be subject to Statement 123R [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], 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]. 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] 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] 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] 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] does not identify a specific line item in the income statement for presentation of the expense related to share-based payment arrangements.

- 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].

- 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] 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 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.

2. Add paragraph 225-10-S00-1 as follows:

Paragraph	Action	Accounting Standards Update	Date
225-10-S99-4	Amended	2009-03	08/24/2009

3. Add paragraph 310-10-S00-1 as follows:

Paragraph	Action	Accounting Standards Update	Date
310-10-S99-4	Amended	2009-03	08/24/2009

4. Add paragraph 605-10-S00-1 as follows:

Paragraph	Action	Accounting Standards Update	Date
605-10-S99-1	Amended	2009-03	08/24/2009

5. Add paragraph 605-15-S00-1 as follows:

Paragraph	Action	Accounting Standards Update	Date
605-15-S99-2	Amended	2009-03	08/24/2009

6. Add paragraph 718-10-S00-1 as follows:

Paragraph	Action	Accounting Standards Update	Date
718-10-S99-1	Amended	2009-03	08/24/2009

7. Add paragraph 730-20-S00-1 as follows:

Paragraph	**Action**	**Accounting Standards Update**	**Date**
730-20-S99-1	Amended	2009-03	08/24/2009

8. Add paragraph 932-360-S00-1 as follows:

Paragraph	**Action**	**Accounting Standards Update**	**Date**
932-360-S99-1	Amended	2009-03	08/24/2009
932-360-S99-2	Amended	2009-03	08/24/2009

9. Add paragraph 980-410-S00-1 as follows:

Paragraph	**Action**	**Accounting Standards Update**	**Date**
980-410-S99-1	Amended	2009-03	08/24/2009