

## **Appendix 14: Accounting Standards and Financial Reporting Requirements for Small Business Investment Companies**

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## ***I. Introduction***

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

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

## ***II. Recordkeeping and Financial Reporting***

### **A. Records and Reports**

All books, records, ledgers, and other supporting documents must be maintained in the English language. See 13 CFR 107.600 through 107.660 for specific requirements relating to the retention of records and the filing of reports with SBA.

### **B. Account Classification**

i. Licensees must maintain their books of account in accordance with the system of account classification prescribed by SBA. The system has been prescribed to ensure that Licensees maintain standard books of account and follow uniform accounting policies. If a Licensee's accounting system cannot reasonably accommodate the account numbers or titles specified by SBA, the Licensee must maintain a listing of its accounts with cross-references to the standard SBIC chart of accounts.

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

### **C. Annual Financial Report (SBA Form 468)**

i. The Small Business Administration, under authority granted by the Small Business Investment Act of 1958, as amended (the Act), requires each Licensee to submit an audited Annual Financial Report as of the close of its fiscal year (see 13 CFR 107.630). The Annual Financial Report consists of the financial statements and other schedules included in SBA Form 468, the Independent Public Accountant's report, the notes accompanying the financial statements, and the required certifications.

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

#### **D. Filing of Annual Financial Report**

i. The Annual Financial Report on SBA Form 468 must be submitted to SBA by the Licensee no later than the last day of the third month following the end of the Licensee's fiscal year. The filing must include a copy of any transmittal letter, special report, or other communication furnished by its auditor.

ii. In accordance with 13 CFR 107.504, SBA Form 468 must be prepared using the electronic reporting software provided by SBA for this purpose. A complete filing of Form 468 consists of the following:

- (1) The data files produced by the Form 468 reporting software (these files may be transmitted to SBA electronically or submitted on a diskette);
- (2) Two printed copies of the financial statements and supplementary schedules;
- (3) The signed management certifications which appear on the last page of Form 468 (two copies, one with original signatures);
- (4) The IPA's report (two copies, one with original signature); and
- (5) The notes to the financial statements (two copies).

#### **E. Portfolio Financing Report (SBA Form 1031)**

For each financing of a small business, Licensees must submit a Portfolio Financing Report on SBA Form 1031 within 30 days of the closing date of the financing. Such reports must be prepared using software provided by SBA and must be electronically transmitted to SBA. Paper copies of the form will be returned to the Licensee for electronic filing. The report, which is used for program evaluation purposes, provides summary information concerning the amount and terms of the financing, the financial condition of the small business and the intended use of proceeds, as well as information that will be used to assess the economic impact of the financing.

#### **F. Interim Reports**

SBA may require Licensees to submit interim reports containing unaudited financial and/or management information, pursuant to 13 CFR 107.660(e). The form and content of such reports may be standardized or determined by SBA on a case-by-case basis.

### ***III. Selection and Qualification of the Auditor***

#### **A. Selection of the Auditor**

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

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

#### **B. Qualification of the Auditor**

Any Certified Public Accountant or Public Accountant, licensed by a regulatory authority of a State or other political subdivision of the United States, may be considered qualified to render an opinion on behalf of a Licensee, provided the following conditions are met: (1) the accountant is independent with respect to the Licensee; (2) the accountant is duly authorized to practice and is in good standing under the laws of the State or other comparable authority in which so authorized; and (3) the accountant carries at least \$1 million of professional liability insurance,

or is self-insured and has a net worth of at least \$1 million (see 13 CFR 107.630(a)(2)). Upon written request, SBA will consider approval of an accountant who does not satisfy the insurance requirement. In responding to such a request, SBA will consider the accountant's experience in performing audits of SBICs or similar entities, as well as other indicators of the complexity and quality of audit work performed.

### **C. Independence**

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

ii. Independence is impaired by circumstances including, but not limited to, the following.

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

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

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

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

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

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

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

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

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

## **IV. Annual Audit**

### **A. Generally Accepted Auditing Standards**

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

### **B. Independent Auditors' Report**

i. The Independent Auditors' Report must conform to AICPA recommendations regarding the application of generally accepted auditing standards to reports on audited financial statements of investment companies. Such

recommendations are presented in chapter 9 of the AICPA publication, "Audits of Investment Companies." It is the responsibility of accountants to be aware of any changes in generally accepted auditing standards which may affect reporting requirements.

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

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

iv. Almost all SBICs have Loans and Investments, the value of which must be estimated by the Board of Directors or General Partner(s) in the absence of readily ascertainable market values. Until the issuance by the AICPA of Statement on Auditing Standards No. 79 (SAS 79) in December 1995, auditors' reports for such SBICs were required to include an explanatory paragraph addressing portfolio valuations. As a result of changes set forth in SAS 79 concerning the reporting of uncertainties, many auditors have concluded that an explanatory paragraph is no longer required under GAAS. SBA has modified its sample auditor's report accordingly; however, inclusion of an explanatory paragraph is specifically permitted if the auditor considers it appropriate (see the optional wording in the third paragraph of the sample report in paragraph vi. of this section).

v. Under Public Law 104-208, effective October 1, 1996, the annual audit of an SBIC must include "a statement by the independent certified public accountant" that a licensee's valuations were prepared in conformity with its SBA-approved valuation policy. This provision is included in section 301(d) of the Act and is incorporated in 13 CFR 107.503(e)(2). SBA has determined that this legal requirement can be satisfied through the use of an explanatory paragraph in the auditor's report on the Form 468 financial statements. The sample report in paragraph vi. of this section includes language which SBA will accept as the required "statement."

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

#### Independent Auditors' Report

The Board of Directors of [Licensee]

or

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

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

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

As discussed in Note x, the investment securities included in the financial statements have been valued by the [board of directors] [general partners] using valuation criteria applicable to the licensee. These criteria were established in accordance with section 310(d)(2) of the Small Business Investment Act of 1958, as amended.

**[NOTE: The remainder of this paragraph is not required, but may be included at the discretion of the auditor.]** Such investment securities have been valued at \$XXXXXX (X percent of net assets), including securities valued at \$YYYYY whose values have been estimated by the [board of directors] [general partner(s)] in the absence of readily ascertainable market values. We have reviewed the procedures used by the [directors] [general partner(s)] in preparing the valuations of investment securities and have inspected the underlying documentation, and in the circumstances we believe the procedures are reasonable and the documentation appropriate. However, in the case of those securities with no readily ascertainable market value, because of the inherent uncertainty of valuation, the [board of directors'] [general partner(s)'] estimate of values may differ significantly from the values that would have been used had a ready market existed for the securities and the differences could be material.

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

Our audit was made for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplementary information contained in the schedules of retained earnings available for distribution and of regulatory and leverageable capital, schedules of commitments and guarantees, and schedules 1 through 8 is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

### **C. Access to Accountants' Working Papers**

In its discretion, SBA may assign its examiners or other personnel to review the accountant's working papers. The audit engagement agreement between the Licensee and the IPA must provide that the accountant's working papers will be made available for review upon request of the SBA (see 13 CFR 107.691).

### **D. Accountants' Responsibility for Valuations**

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

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

- (1) Does the Licensee have a written valuation policy that has been approved by SBA?
- (2) Do the Licensee's valuations of its portfolio concerns reflect consistent adherence to its valuation policy?
- (3) Has the Licensee documented the basis for its valuations, and does such documentation indicate that a reasonable analysis of available information has been performed?

iii. SBA requirements concerning portfolio valuations are set forth in its "Valuation Guidelines for SBICs." These guidelines contain recommended valuation techniques for securities of various types, as well as requirements concerning the adoption of a written valuation policy, frequency of valuation, and documentation. A Licensee has the option of adopting the model valuation policy included in the guidelines or obtaining SBA approval of an alternative valuation policy (see 13 CFR 107.503).

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

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

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

### **E. Audit Adjustments**

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

### **F. Reporting Irregularities**

i. *Reporting Irregularities and Illegal Acts to SBA.* An independent public accountant who detects irregularities or illegal acts individually or collectively material to the financial statements, or irregularities or illegal acts relative to SBA programs whether or not material, must advise management in writing. Within one business day following receipt of the auditor's report, management must notify, in writing, the Associate Administrator for Investment, Investment Division, 409 Third Street, SW, Washington, DC 20416. Management, in advising SBA, must, to the extent practicable, describe the irregularities or illegal acts and their effects on the financial statements and SBA programs. Auditors are responsible for determining whether management reported the irregularities or illegal acts to SBA. If the auditor does not receive a copy of management's notice to SBA within the one business day notification period, then by the end of the next business day the auditor must furnish directly to SBA, at the address listed above, a copy of the report given to management.

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

### **G. Detecting Noncompliance with Laws and Regulations**

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

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

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

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



2. *Code of Federal Regulations, title 13, parts 107 and 121 (13 CFR 107 and 121)*. Part 107 contains the regulations governing the SBIC program, and auditors should become familiar with this part in its entirety. Part 121 contains small business size regulations which apply to various SBA programs; particular attention should be given to the definition of "Affiliation" (13 CFR 121.103) and the SBIC size standard (13 CFR 121.301(c)).

iv. In addition to the Act and regulations themselves, SBA has various materials available which may assist auditors in developing an overall understanding of the SBIC program. These include basic informational brochures about the program; the preambles to final rules published in the Federal Register, which provide rationales for and interpretations of new regulations; and a regulatory compliance checklist for small business financings.

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

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

## **V. Accounting Policies and Procedures**

### **A. Generally Accepted Accounting Principles**

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

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

iii. SBA, as the regulator and major creditor of the SBIC industry, has tailored Form 468 to provide financial information in a format that will satisfy SBA's analytical and regulatory requirements. An IPA must exercise professional judgment in determining whether reporting on Form 468 requires a material departure from GAAP for a particular SBIC. If such a departure exists, the Independent Auditors' Report may be modified accordingly.

### **B. Accrual Basis of Accounting**

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

### **C. Reporting Entity**

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

ii. *Investment in Management Services Company*. A Licensee is permitted to organize a wholly owned corporation solely to provide management services to small businesses. In this case, financial reports submitted to SBA must reflect the consolidated results of the Licensee and its subsidiary.

iii. *Investment in special purpose investment subsidiary.* Subject to SBA's prior written approval, some Licensees may be permitted to form one or more wholly owned corporations to make and hold certain investments in portfolio concerns (see 13 CFR 107.720(b)(3)). Financial reports submitted to SBA must reflect the consolidated results of the Licensee and any such subsidiaries.

iv. *Investment in Section 301(d) Licensee.* Under 13 CFR 107.120, a Section 301(d) Licensee may be licensed to operate as the subsidiary of one or more Licensee companies ("Participant Licensees"), with or without non-Licensee participation. Each Participant Licensee must own at least 20 percent of the voting securities of the Section 301(d) Licensee. Such an investment must be reported on the equity method, under the caption "Investment in 301(d) Licensee" on the Statement of Financial Position. SBA recognizes that this accounting treatment may constitute a departure from GAAP if the Participant Licensee is the majority owner of the Section 301(d) Licensee. The independent public accountant may wish to express a qualified opinion if the departure is considered material.

iv. *Temporary Control.* Under certain circumstances, as described in 13 CFR 107.865, a Licensee may temporarily own more than a 50 percent interest in a small business concern. These investments must be classified in the appropriate category of Loans and Investments on the Statement of Financial Position (generally, this will be "Operating Concerns Acquired"), and must be reported at their fair value. This treatment is consistent with FASB Statement No. 94, which provides an exception to the general rule of consolidating majority-owned subsidiaries when control is likely to be temporary.

#### **D. Fair Value of Loans and Investments**

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

ii. SBA requirements concerning portfolio valuation are set forth in 13 CFR 107.503 and 107.650, supplemented by "Valuation Guidelines for SBICs". Licensees may adopt the model valuation policy included in the guidelines or submit an alternative policy to SBA for approval. In addition to valuation policy, the regulations and valuation guidelines also set forth requirements concerning frequency of valuation, documentation, responsibility for valuations and reporting of valuations to SBA.

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

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

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

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

### **E. Interest Income**

i. Interest income must be accrued according to the terms of interest bearing loans and investments. Premiums or discounts associated with debt instruments represent adjustments to interest income which must be amortized over the stated life of the debt instrument.

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

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

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

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

vi. When the accrual of interest is discontinued, the full amount of any interest receivable recorded in prior periods must be either reversed or fully reserved, unless the Licensee can provide evidence of collectibility satisfactory to SBA.

### **F. Dividend Income**

i. Dividend income from investments in common or preferred stock is normally recognized as of the date of record (the date at which official ownership of shares is determined for the purpose of paying the dividend). Dividend income cannot be accrued in the absence of a dividend declaration by the small business's board of directors. This treatment applies to all dividends, including dividends on redeemable preferred stock or similar securities with some debt-like characteristics.

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

iii. Stock splits and stock dividends that have no effect on the relative ownership percentages of shareholders do not result in the recognition of income. The cost of the shares previously held should be allocated, on a rational basis, to the number of shares held after the split or dividend. Similarly, when stock rights are received, a portion of the cost basis of the related investment may be allocated to the rights.

iv. Dividends in kind (generally dividends received in the form of shares of a portfolio concern) that increase a Licensee's proportionate ownership interest are recorded as income at the fair value of the property received. Such

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

### **G. Profit Participation in Small Concerns**

Participation in the profits of a debt-financed small business concern represents income to the Licensee. For regulatory purposes, any profits received must be included in the calculation of the Cost of Money unless the profit participation satisfies the criteria for an excludable one-time "bonus" as described in 13 CFR 107.855(i).

### **H. Fees Charged to Small Concerns**

i. Nonrefundable fees charged by SBICs in connection with the origination of loans, net of related direct loan origination costs, generally should be deferred and amortized over the term of the financing. Alternatively, Licensees may recognize such fees (net of related costs) as income in the period in which the loan is originated if such treatment is appropriate under GAAP. Licensees should be aware of the provisions set forth in 13 CFR 107.855 and 107.860 concerning permissible fees and expense reimbursements, and the extent to which such items may be excluded from the Cost of Money.

ii. If a Licensee has made a commitment for a financing which does not take place, any "break-up fee" to which the Licensee is contractually entitled is recognized as income when due (see 13 CFR 107.860(g)).

### **I. Accounting for Investments in Flow-Through Concerns**

i. SBICs are permitted to invest in small businesses organized as flow-through entities. This category of investments includes any entity that passes through its income and losses to its owners and is not taxed at the entity level, such as a limited partnership or limited liability company.

ii. Investors in such entities typically use the equity method, under which (1) original cost is adjusted at the end of each accounting period to recognize the investor's share of the income or losses of the investee; (2) the amount of the adjustment is included in the net income of the investor; and (3) distributions received from the investee reduce the carrying amount of the investment. However, this method is not appropriate for investors such as SBICs, which account for their investments at fair value.

iii. Instead of using the equity method, Licensees with portfolio investments in flow-through entities must report these investments at their fair value in the Statement of Financial Position, with the difference between cost and value reflected as unrealized appreciation or depreciation. Any income or loss allocated to the Licensee may, if appropriate, be a factor in the Licensee's estimate of the investment's fair value, but such allocations are not recognized as income or loss in the Statement of Operations Realized; furthermore, the Licensee's cost basis is not adjusted to reflect such allocations. Licensees are to recognize income or loss when realized upon disposition or liquidation of all or part of their ownership interest. Income is also recognized when the Licensee receives a distribution from the investee, as long as the distribution is not a return of capital. Returns of capital do not result in the recognition of income, but are treated as a reduction of the Licensee's cost basis.

iv. Licensees that have previously used the equity method to account for their investments in flow-through entities, based on previous SBIC accounting guidelines issued by SBA, may contact SBA to discuss whether it would be appropriate to implement a change of method for these investments.

### **J. Equity Method of Accounting**

i. The only type of investment that a Licensee must account for under the equity method is an investment in the common stock of a Section 301(d) Licensee, as permitted under 13 CFR 107.120. Since a Licensee investing in a Section 301(d) Licensee is required to have an ownership interest of at least 20 percent, use of the equity method will normally be appropriate. Under the equity method, original cost is adjusted at the end of each accounting period to

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

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

### **K. Accounting for Income Taxes**

i. In February 1992, the FASB issued Statement No. 109, "Accounting for Income Taxes", which established the following basic principles to be applied in accounting for income taxes at the date of financial statements:

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

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

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

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

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

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

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

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

### **L. Realized Gain (Loss) on Investments**

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

ii. Capital gains realized on the sale of securities must be recognized provided that collection of proceeds is reasonably assured and the earnings process is complete. For the earnings process to be considered complete, the

Licensee must have no further obligation related to the transaction. Any transaction with recourse upon the Licensee or involving any understanding, agreement, option, privilege, or other rights to repurchase by and/or resell to the Licensee is not considered a final transaction. Transactions which do not meet the criteria in this paragraph L for current recognition of gains must be accounted for using an appropriate alternate method, such as the installment method or the cost recovery method. Under the installment method, a portion of the gain is recognized with each installment payment received; under the cost recovery method, no gain is recognized until the full amount of the seller's cost has been collected.

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

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

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

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

#### **M. Nonmonetary Transactions**

i. Licensees should follow APB Opinion No. 29 to the extent applicable when accounting for nonmonetary transactions. Such transactions include both reciprocal and non-reciprocal transfers of nonmonetary assets or liabilities between the Licensee and another entity or person, or between the Licensee and its stockholders or partners. The cost of an asset acquired in a non-monetary transaction is the fair value of the asset relinquished to obtain it, and a gain or loss should be recognized on the exchange. Any gain recognized must be reported on SBA Form 468 as a Non-cash Gain.

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

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

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

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

#### **N. Interest, Notes and Accounts Receivable**

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

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

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

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

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

vi. *Notes and Accounts Receivable.* The accounting treatment of notes receivable and accounts receivable is governed by the same rules which apply to interest receivable, as previously described in this paragraph N.

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

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

#### **O. Compensating Balances**

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

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

#### **P. Organization Costs**

i. Organization costs are incurred in the formation of an SBIC and may include such items as legal fees, incorporation and various other fees imposed by states, and promotional expenditures. Until the issuance by the AICPA of Statement of Position 98-5 (April 3, 1998), organization costs were capitalized and amortized over a period of 5 years. However, the Statement of Position now requires that organization costs be expensed as they are incurred. SBA is conforming these accounting guidelines to the Statement of Position, which is effective for fiscal years beginning after December 15, 1998 (earlier application is encouraged in fiscal years for which financial statements have not been issued).

ii. If an SBIC incurs organization costs that SBA deems to be unreasonable or excessive, such costs must be excluded from Regulatory Capital.

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

#### **Q. Contingent Liabilities**

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

ii. In addition to the reporting requirements of FASB Statement No. 5, Licensees and their IPAs should be familiar with SBA's requirements for reporting of certain contingencies. These additional requirements include the completion of the Schedule of Guarantees (included in SBA Form 468) by Licensees which have guaranteed the obligations of small concerns and the filing of a litigation report by Licensees which become a party to litigation (see 13 CFR 107.660(c)).

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

#### **R. Transactions with Related Parties**

i. Licensees must disclose material transactions with related parties in accordance with FASB Statement No. 57. In applying the requirements of this pronouncement to SBIC financial statements, a Licensee must consider the term "related party" to encompass any person or entity that is an Associate as defined in 13 CFR 107.50. Footnote disclosures of related party transactions must include the name of the related party as well as the nature of the relationship.

ii. Licensees and their IPAs should be aware that certain transactions involving Associates are either prohibited by SBA regulations or permitted only with SBA's prior written approval. See 13 CFR 107.730 ("Financing which constitute conflicts of interest").

#### **S. Leverage--Debentures Guaranteed or Purchased by SBA**

i. SBICs which qualify on the basis of financial soundness and regulatory compliance are eligible to receive long-term leverage in the form of 5-year or 10-year debentures guaranteed (or, in some cases, purchased directly) by SBA. Some Section 301(d) Licensees may have outstanding debentures with an interest rate subsidy of 3 percentage points for the first 5 years of their term. Such subsidized debentures were available to Section 301(d) Licensees prior to October 1, 1996.

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

iii. A Licensee seeking to issue debentures must first obtain SBA's conditional commitment to reserve a specific amount of debenture leverage for the Licensee's future use. The Licensee pays a leverage fee to SBA (currently 3 percent of the amount borrowed) and an underwriter's fee (currently 0.5 percent). The leverage fee is paid in two stages: the Licensee pays 1 percent of the committed amount when the commitment is received and pays 2 percent of the amount of each takedown as it draws the funds.

iv. Fees associated with the issuance of debentures must be capitalized and amortized over the life of the debenture. Generally accepted accounting principles normally require that debt be reported net of the unamortized portion of related fees; on Form 468, however, Licensees should report the unamortized fees as an asset and the debentures at their gross amount. SBA does not believe that this treatment will constitute a material departure from GAAP for most Licensees.

v. If a leverage commitment from SBA expires without being fully utilized, the Licensee must expense the leverage fees associated with the unused portion.

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



financial and regulatory conditions, which may result in the entire indebtedness of the Licensee being declared due and payable.

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

#### **T. Leverage--Participating Securities Guaranteed by SBA**

i. Participating Securities are redeemable preferred equity-type securities. Issuers are required to make equity investments in an amount at least equal to the amount of Participating Securities issued (see the defined term "Equity Capital Investments" in 13 CFR 107.50 for the specific categories of investments permitted). The structure, terms and conditions of the Participating Security are set forth in detail in 13 CFR 107.1500 through 107.1590.

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

iii. The Participating Security has the following significant features:

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

(2) Licensees that are unable to pay Prioritized Payments in full as of the end of any fiscal year must perform a compounding calculation on the unpaid balance in accordance with 107.1520(f). The amounts computed under this section ("Adjustments" to Prioritized Payments) are payable under the same terms and conditions as the Prioritized Payments themselves. In addition, Participating Securities issued after October 1, 1996 (except for those issued pursuant to a leverage commitment issued by SBA before that date) are subject to an additional charge of 1 percent per annum, payable to SBA under the same terms and conditions as Prioritized Payments.

(3) In consideration for SBA's guarantee, profitable Licensees must pay a percentage of earnings (after Prioritized Payments) to SBA as "Profit Participation". SBA's profit percentage (the "Profit Participation Rate") depends upon the Licensee's ratio of Participating Securities issued to Leverageable Capital, as well as the interest rate on 10-year Treasury securities at the time each Participating Security was issued. The Profit Participation Rate formula is in 13 CFR 107.1530.

(4) Except for Prioritized Payments, SBA (the "Preferred Limited Partner") and the Licensee's private limited partners receive distributions at the same time, allocated in accordance with formulas established by law. SBA will apply its share of such distributions either as Profit Participation or as a redemption of Participating Securities in accordance with 13 CFR 107.1550 through 107.1570.

(5) The Participating Securities have a 10-year term, at the end of which redemption is mandatory. Participating Securities can be redeemed without penalty, in whole or in part, at any time prior to the scheduled maturity date. Under certain circumstances, early redemption of Participating Securities is mandatory (see 13 CFR 107.1560).

(6) In the event of the liquidation of a Licensee, the following will be senior in priority to all other equity interests issued by the Licensee at any time:

(a) Any outstanding Participating Securities;

(b) Any Prioritized Payments, Adjustments, and additional 1 percent charges which the Licensee has sufficient profits to pay (see the computation of "Earned Prioritized Payments" and earned Adjustments and Charges in 13 CFR 107.1520); and

(c) Any Profit Participation allocated to SBA under 13 CFR 107.1530.

iv. Participating Securities are reported in a "Redeemable Securities" section of the Statement of Financial Position on SBA Form 468. The amount of Participating Securities issued represents the capital contribution of SBA, the Preferred Limited Partner. Prioritized Payments and Profit Participation both represent an allocation of profit to SBA, rather than an expense of the Licensee. For purposes of reporting to SBA on Form 468, Prioritized Payments and Profit Participation should be allocated to SBA only on the basis of realized profits; unrealized gain on securities held should remain unallocated in the Capital section of the Statements of Financial Position.

v. Although Participating Securities have some debt-like characteristics, they are generally considered to be equity-type securities. As a result, the leverage fees paid by issuers (as described in paragraph S.iii. of this section) may be considered analogous to partnership syndication costs, which would be offset against the partners' capital under GAAP. However, SBA has determined that Participating Securities issuers are entitled to deduct these costs when performing the required profit and distribution computations. For this purpose, under 13 CFR 107.1510(d)(1), Licensees are to treat such costs as being capitalized and amortized on a straight-line basis over not less than 5 years. Licensees may report leverage fees in this manner on Form 468, or they may follow a GAAP presentation and adjust their Participating Securities computations accordingly. The footnotes to the financial statements should clearly indicate the method used.

vi. In a footnote to the financial statements, the Licensee must provide a description of the terms of the Participating Securities issued, including disclosure of the mandatory redemption date. If there are any "accumulated" Prioritized Payments (representing a contingency for amounts paid to certificate holders by SBA on the Licensee's behalf, which the Licensee must repay as profits are realized), a footnote must disclose the dollar amount of the accumulation (including any Adjustments and the additional 1 percent charge) for the current fiscal period and the aggregate amount accumulated.

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

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

#### **U. Preferred Stock Leverage for Section 301(d) Licensees**

i. *Four Percent Preferred Stock.* Prior to October 1, 1996, Section 301(d) Licensees were eligible to receive long-term leverage by selling 4 percent redeemable preferred stock directly to SBA (Section 301(d) Licensees organized as limited partnerships could issue equivalent securities in the form of a preferred limited partnership interest, but none actually did so). Any such securities still outstanding must be redeemed not later than 15 years from the date of issuance, at which time any unpaid portion of the preferred and cumulative 4 percent dividend due to SBA must also be paid. No distributions may be made to any investor other than SBA unless the Licensee is current on all amounts due SBA.

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

iii. The initial carrying amount of 4 percent preferred stock is the purchase price paid by SBA at the date of issue (which must be equal to the par value). At the end of each accounting period, the carrying amount must be increased by the amount of any 4 percent dividends not currently paid or declared. A breakdown of the total carrying amount, showing separately the purchase price of 4 percent preferred stock and the accrued 4 percent dividends in arrears, is reported on the Statement of Financial Position.

iv. Cumulative 4 percent dividends in arrears must be recorded as a charge against Undistributed Net Realized Earnings. For some Section 301(d) Licensees, these amounts may exceed Undistributed Net Realized Earnings. Ordinarily, a company in these circumstances would reduce paid-in capital by the amount of the excess. Because such treatment would reduce Regulatory Capital, however, it could result in certain unintended regulatory compliance problems for Licensees (such as overline violations). Therefore, on SBA Form 468, Licensees must report all 4 percent dividends in arrears as a reduction of Undistributed Net Realized Earnings, even though this treatment may result in a deficit, and must not reduce paid-in capital.

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

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

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

viii. No dividends may be paid to any investor other than SBA unless the Licensee is current on all 3 percent preferred dividends due SBA. The amount of any preferred dividends in arrears must be disclosed in a footnote to the financial statements.

ix. *Three Percent Preferred Stock Repurchase Program.* On April 1, 1994, SBA published a notice in the Federal Register announcing the implementation of a program under which Section 301(d) Licensees may apply to repurchase their outstanding 3 percent preferred stock from SBA at a set price of 35 percent of par value. Specific guidelines governing repurchase transactions are set forth in the Federal Register notice and in SBA Policy and Procedural Release #2021, issued June 14, 1994. A Federal Register notice published on July 22, 1997, extended the availability of the Repurchase Program by 4 years to June 14, 2001.

x. SBA provides accounting guidelines governing the repurchase transaction to all participants in the Repurchase Program. Copies of these guidelines are available from the Investment Division upon request.

## V. Contributed Capital and Committed Capital

i. In general, "contributed capital" refers to funds contributed to a Licensee by private investors (although such funds may also include "qualified nonprivate funds" from Government sources, in accordance with the definition of Private Capital in 13 CFR 107.230). Although some Licensees may obtain financial assistance through the issuance of equity-type securities purchased or guaranteed by SBA, such securities are reported on Form 468 as SBA leverage rather than as contributed capital. The contributed capital of a corporate Licensee consists of the par value of its capital stock (which may consist of one or more classes of stock) and its aggregate paid-in surplus, excluding Restricted Contributed Capital Surplus obtained through the repurchase of 3 percent preferred stock from SBA. For a partnership Licensee, contributed capital consists of proceeds from the sale of partnership interests to the general partners and the limited partners (other than SBA). For all Licensees, contributed capital must be recorded net of expenses incurred to obtain the capital.

ii. Capital contributed to a Licensee in the form of non-cash assets requires the prior approval of SBA, unless the assets fall into certain specified categories (for example, tangible assets to be currently employed by the Licensee in its operations; see 13 CFR 107.240). Equity securities issued in exchange for non-cash assets will be excluded from a Licensee's Regulatory Capital until the assets received are converted to cash, unless SBA specifically approves their inclusion.

iii. *Commitments from Investors.* In addition to its contributed capital, a Licensee may have outstanding commitments from individuals or entities to invest additional funds in the Licensee at a future date. Binding

commitments from Institutional Investors (as defined in 13 CFR 107.50) are included in the Licensee's Regulatory Capital; the principal effects of such inclusion are to increase the Licensee's overline limitation (see 13 CFR 107.740) and to increase the capital base used in the computation of Capital Impairment (see 13 CFR 107.1830).

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

### **W. Unrealized Gain (Loss) on Securities Held**

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

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

### **X. Undistributed Realized Earnings**

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

ii. *Non-cash Gains/Income* includes such items as: (1) gains on the disposition of securities realized in the form of notes, securities or any other non-cash assets; (2) income recognized under the equity method of accounting; (3) dividends received in kind; (4) interest income accrued on deferred interest notes, zero coupon bonds or similar instruments; and (5) delinquent accrued interest converted into a new note or added to the principal of an existing note (the amount of such interest which is included in Undistributed Net Realized Earnings must be reclassified to Non-cash Gains/Income). Interest income recognized through normal year-end interest accruals associated with current-pay debt instruments should not be classified as Non-cash Gains/Income.

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

iv. Classification of capital gains or other income as non-cash items is generally intended to be temporary. As a Licensee receives payments on a note, receives distributions from a partnership in which it has invested, sells shares of stock received as a dividend or otherwise converts non-cash assets to cash, amounts initially reported as Non-cash Gains/Income are reclassified as Undistributed Net Realized Earnings.

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

## **Y. Retained Earnings Available for Distribution**

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

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

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

iv. For Section 301(d) Licensees that have issued 4 percent preferred stock, there is one additional element in the computation. Because 4 percent dividends in arrears are accrued and charged against Undistributed Net Realized Earnings, they must be added back to determine Retained Earnings Available for Distribution. In this case, the balance of Retained Earnings Available for Distribution may be distributed only to SBA until all 4 percent dividends are paid in full.

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

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

vii. *Capitalization of Retained Earnings Available for Distribution.* Ordinarily, contributed capital and earned capital are maintained and reported separately. In the SBIC program, however, a Licensee with positive Retained Earnings Available for Distribution (READ) has the option of "capitalizing" such earnings by permanently reclassifying them as contributed capital. As a result of the reclassification, Undistributed Net Realized Earnings are reduced, while paid-in capital is increased; the net effect is the same as if the Licensee had made a distribution to its owners, who then reinvested the same amount in the Licensee. From a regulatory perspective, this action results in an increase in the Licensee's Leverageable Capital, thus increasing its eligibility for SBA leverage. Capitalization of READ reflects the intent of a Licensee to pursue long-term growth by reinvesting its earnings in small businesses. In order to be eligible to capitalize READ, an SBIC must have paid any amounts due to SBA on a priority basis (such as Prioritized Payments or the preferred dividends on 3 percent and 4 percent preferred stock). For all regulatory purposes, capitalization of READ constitutes a distribution to the Licensee's non-SBA investors.

viii. *1940 Act Companies.* A Licensee that has registered under the Investment Company Act of 1940 may elect to be taxed as a regulated investment company under section 851 of the Internal Revenue Code of 1986, as amended. In general, such a company can avoid taxation at the corporate level if it distributes at least 90 percent of its investment company taxable income for a given year. Licensees which are (or contemplate becoming) 1940 Act companies should be aware that the distribution requirements imposed on such companies by the Internal Revenue Code may, under certain circumstances, conflict with SBA regulations concerning distributions to shareholders. SBA regulations allow profit distributions to be made only from Retained Earnings Available for Distribution. Any distribution that would exceed Retained Earnings Available for Distribution requires the prior written approval of SBA.

### **Z. Partnership Capital Accounts**

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

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

iii. *Unrealized Gain (Loss) on Securities Held.* This component of partnership capital results from the valuation of Loans and Investments by the General Partner(s). Unrealized appreciation is recognized for valuations above cost and unrealized depreciation is recognized for valuations below cost. Unrealized gain or loss is the sum of the unrealized appreciation or depreciation of all Loans and Investments. Estimated future tax effects associated with unrealized appreciation or depreciation are not taken into account because partnerships are not taxed at the entity level. For further information, see paragraph W of this section V.

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

### **VI. Availability of Publications and Forms**

i. This section contains information about where to obtain various publications and forms cited in these guidelines.

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

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

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