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CURRENT ACCOUNTING ISSUES AND RELATED DEVELOPMENTS AFFECTING THE DIVISION OF CORPORATION FINANCE
(as of October 16, 1992)

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CURRENT ACCOUNTING ISSUES AND RELATED DEVELOPMENTS AFFECTING THE DIVISION OF CORPORATION FINANCE (as of October 16, 1992)

I. Recently Adopted Rules and Interpretive Releases

A. Small Business Initiatives

On July 30, 1992, the Commission adopted new rules and forms under the Securities Act of 1933, the Securities Exchange Act of 1934, and the Trust Indenture Act of 1939 to facilitate capital raising by small businesses. Specifically, the Commission revised Regulation A and Rule 504 of Regulation D to expand the categories of companies eligible to use those exemptions and increased the dollar ceiling for an offering under Regulation A. In addition, for "small business issuers" reporting under the Securities Act and the Exchange Act, the Commission adopted a system of simplified registration and reporting.

1. Integrated Disclosure System for Registration and Reporting for Small Business Issuers

The Commission adopted a new integrated disclosure system for Small Business Issuers. The system consists of specialized forms under the Securities Act and the Exchange Act that reference disclosure requirements located in one central depository - Regulation S-B. The new forms adopted by the Commission include forms SB-2, 10-SB, 10-QSB, and 10-KSB. Old Form S-18 has been rescinded. The new disclosure system for small business issuers is optional: an issuer that would qualify as a small business may elect to continue to use the present reporting system.

A small business issuer is defined as a U.S. or Canadian entity that meets all of the following tests:

* revenues of less than $25 million,
* the aggregate market value of the entity's voting stock held by non-affiliates (referred to as the "public float") is less than $25 million,
* if the small business issuer is a majority owned subsidiary of another company, its parent must also meet the definition of a small business issuer, and
* investment companies are excluded from the definition.

An estimated 3,000 reporting public companies fall within the definition of a small business issuer.

The information required by Regulation S-B is substantially the same as that required by old Form S-18. The financial statements required to be included in small business registration statements and annual reports are an audited balance sheet as of only the most recently completed year end (unless such year end occurred within the last 90 days) and statements of operations and cash flows for each of only the last two fiscal years. Interim financial statements must be provided if the fiscal year end financial statements are more than 135 days old. Both annual and interim financial statements must comply with generally accepted accounting principles, but are not required to comply with Regulation S-X. Financial statement schedules are not required to be included in filings on small business forms. The narrative disclosure requirements in Regulation S-B generally parallel those of Regulation S-K, but where such requirements were simplified or not omitted by Form S-18, Regulation S-B generally tracks the reduced requirements of Form S-18.

In connection with the development of Regulation S-B, Item 17A (disclosures concerning mining operations) of old Form S-18 has been redesignated as Guide 7 under the Securities Act and Exchange Act. The Commission indicated in the adopting release that small business issuers engaged in operations involving real estate, mining, insurance, banking, utilities, and oil and gas should also refer to the applicable industry guide. In addition, roll-up transactions are required to furnish the disclosure required by subpart 900 of Regulation S-K.

Form SB-2 is the new designated Securities Act registration form for small business issuers. There is no dollar limit for offerings on Form SB-2 and the form may be used for both initial and repeat offerings. Although old Form S-18 was rescinded, filings on that form will be accepted for filings through December 31, 1992.

For a company entering the Commission's disclosure system, either through a Securities Act or an Exchange Act registration statement, its eligibility to use the optional SB system will depend on the level of its revenues in its last full fiscal year, and its capitalization as of a date within 60 days prior to the offering in a Securities Act registration statement or the filing of the registration statement under the Exchange Act. The determination as to the reporting category at the time a non-reporting company enters the

disclosure system (i.e. the use of Form S-1 or Form SB-2) governs all reports relating to the remainder of the fiscal year. A small business issuer that elects to file its initial registration using Form S-1 must report for the remainder of its fiscal year pursuant to Regulation S-K and Regulation S-X. After the initial registration statement, a company may continue to report under the SB system until it exceeds the revenue test for two consecutive years or the public float test for two consecutive years, based on its annual report on Form 10-KSB.

In order for a company currently reporting with the Commission to enter the SB disclosure system, it must meet the definition of a small business issuer for two consecutive years. The determination made for a reporting company at the end of its fiscal year (after filing its Form 10-K or 10-KSB) governs all reports relating to the next fiscal year. An issuer may not change from one category to another with respect to its reports under the Exchange Act for a single fiscal year.

Notwithstanding an issuer's classification as a small business, small business issuers are permitted to register securities on Forms S-2, S-3 and S-8 if they otherwise meet the eligibility requirements for use of those forms. References in those forms to the disclosure requirements of Regulation S-K will be deemed to be references to Regulation S-B for small business issuers. Form SB-2 is available only for the registration of securities to be sold for cash. Accordingly, small business issuers wishing to enter business combination transactions which involve the registration of securities will continue to be required to register those transactions on Form S-4 or Form S-1. If a small business issuer elects, or is required, to use Form S-1, the filing must contain all the disclosure requirements of Regulation S-K and the financial statements required by Regulation S-X.

2. Proposing Release - Additional Initiatives Relating to SB Disclosure System

In a companion release, the Commission has proposed additional measures to ease a small business issuer's transition from non-reporting to reporting status and to simplify the disclosure requirements for small business issuers that engage in exempt offerings.

Under these proposals, a small business issuer may enter the reporting system using Regulation A

disclosure and only one year of audited financial statements either through an Exchange Act registration statement or a public offering of not more than $5 million. These small business issuers would be permitted to meet their reporting requirements using the Regulation A model of disclosure until such time as they either (1) register more than $5 million in a single fiscal year, (2) elect to graduate to the standard small business disclosure system, or (3) are no longer small business issuers.

In order to implement this transitional system, amendments to Forms S-2, S-4, 10-SB, 10-KSB, and 10-QSB are proposed, in addition to amendments to Schedule 14A under the proxy rules. Further a new Securities Act registration statement, Form SB-1, is proposed to permit qualifying small business issuers to make small registered offering up to $5 million annually using the Regulation A format with only one year of audited financial statements.

Two refinements to the financial statement requirements for small business issuers are also proposed. The first proposal would provide an automatic waiver of the requirements for audited financial statements of specified significant acquired businesses if the required audited financial statements are not otherwise available. If an issuer has other financial statements or information which constitute less than the full audited financial statements required, such other financial statements or information will be required to be provided. Under the proposal, if none of the conditions in the definitions of significant subsidiary exceeds 20%, and the required audited financial statements are not readily available, an automatic waiver of the required audited financial statements would be granted. In addition, if none of the conditions in the definitions of significant subsidiary exceeds 40% and the required audited financial statements are not readily available, an automatic waiver would be available for the fiscal year preceding the latest fiscal year. The other proposal would widen the initial public offering (IPO) financing window for small business issuers by permitting them to proceed throughout the first quarter of their fiscal years without having to wait for completion of the audit for the preceding fiscal year, rather than update 45 days after fiscal year-end.

3. Changes to Regulation A

The new rule raises the dollar ceiling for a Regulation A offering from $1,500,000 to $5,000,000, including no more than $1,500,000 in non-issuer resales. The Regulation A exemption is now available to all U.S. and Canadian issuers not subject to Section 13 or 15(d) of the Exchange Act, except the following:

* "blank check" companies (issuers having no specific business or plan),
* investment companies required to be registered pursuant to the Investment Company Act of 1940,
* registrants issuing fractional undivided interests in oil or gas rights or similar interests in other mineral rights,
* registrants disqualified because of the "Bad Boy" disqualification provisions of Section 262 of Regulation A.

The Commission's safe harbor provisions for forward looking information have been revised to apply to statements made in a Regulation A offering statement. Therefore, good faith projections, with a reasonable basis, of revenues, income, earnings per share, capital expenditures, dividends, capital structure and other financial items may be made in Regulation A filings under the same conditions as for other Commission filings.

As discussed in the March Proposing Release, one of the major impediments to a Regulation A financing for a small start-up or development company was the costs of preparing the mandated offering statement without knowing whether there would be any investor interest in the company. To remedy this situation, the Commission adopted the proposal to permit companies relying on the Regulation A exemption to "test the waters" for potential interest in the company prior to filing and delivery of the mandated offering statement. As adopted, the "testing of the waters" must begin with a written solicitation of interests. The solicitation document must also be submitted to the Commission at the time of its first use. Although the rules generally provide for a "free writing" of the solicitation document, the document must include the following items:

(a) a statement that no money is being solicited, or will be accepted; that no sales can be made until delivery and qualification of the offering circular, and that indications of interest involve no obligation or commitment of any kind; and

(b) a brief, general identification of the company's business, products and chief executive officer.

Once the offering statement required by Regulation A is filed with the Commission, the issuer may not continue to use its written "test the waters" solicitation materials.

4. Changes to Rule 504 of Regulation D

Under new Rule 504, a public offering of up to $1 million in a 12-month period by a non-Exchange Act reporting company is subject only to the anti-fraud and other civil liability provisions of the federal securities laws. This change eliminates the conditions regarding state registration previously imposed by the Rule. In addition, new Rule 504 permits general solicitation and general advertisement in connection with all offers and sales under the exemption.

The Commission excluded blank check companies from new Rule 504. While former Rule 504, now Rule 504a, is still available to blank check companies, the Commission has issued a proposal that would revoke entirely a blank check's eligibility to conduct such offerings.

In light of the adopted amendments to Regulation A discussed above, the Commission is also proposing to amend the financial statement and information requirements of Regulation D. As proposed, Rule 502 would no longer require audited financial statements in Regulation D offerings involving non-reporting issuers, where audited statements are not otherwise available. Further, that Rule's information requirements with respect to non-reporting companies would reference Regulation A. In light of public comment received regarding revisions to Rule 504, the Commission is proposing that Rule 504a be deleted.

B. Technical Amendments to Regulation S-X

On September 17, 1992, the Commission adopted amendments to various rules and forms needed to conform the Commission's requirements with recently adopted accounting standards (Securities Act Release No. 33-6958). Since December 1986, the Financial Accounting Standards Board (FASB) has issued several Statements of Financial Accounting Standards (SFAS) that result in reporting requirements that are duplicative of, or in some instance, different from the Commission's requirements. The amendments are intended to eliminate duplicative and obsolete disclosures and to achieve

consistency between existing accounting principles and the Commission's rules, forms and policies.

The amendments reflect reporting changes relating to adoption of SFAS No. 109, issued in February 1992, addressing accounting and reporting by insurance companies for certain long duration contracts and for realized gains and losses from sales of investments; SFAS No. 96, issued in December 1987, establishing a liability approach to accounting and reporting for income taxes; SFAS No. 95, issued in November 1987, requiring presentation of a statement of cash flows within a set of financial statements; and SFAS No. 91, issued in December 1986, prescribing new accounting for non-refundable fees and costs associated with originating or acquiring loans and initial direct costs of leases. The Commission also is deleting Rule 4-10(k) of Regulation S-X that requires supplemental disclosures of oil and gas producing activities because substantially similar disclosure requirements are included in SFAS No. 69.

II. Recently Proposed Rules

A. Age of Financial Statements for Offerings by Foreign Private Issuers

On June 5, 1991, the Commission published for comment proposed amendments to Regulation S-X Rule 3-19, Securities Exchange Act Rule 15d-2 and Forms F-2 and F-3 which relate to the age of financial statements of foreign private issuers. The proposed amendments would extend the Securities Act and Exchange registration statement updating requirement for annual audited financial statements of foreign private issuers by one month and would extend the updating requirement for interim audited financial statements by four months. In addition, the maximum age of financial statements in a Securities Act filing would be extended from six months to one year. The proposed updating requirements corresponds to the semi-annual interim reporting requirements of the EEC and several countries. The proposed amendments are intended to enable foreign issuers to make offerings in the U.S. and to facilitate their continuous offerings without imposing the U.S. quarterly reporting scheme upon such issuers.

The proposals would amend Rules 3-19(b) and (c) to establish a scheme in which there will be no periods in which an offering could not go effective or during which continuous offerings would be suspended as long

as the foreign issuer can provide audited fiscal year and unaudited interim financial statements within six months following the fiscal year end and four months following the end of the semi-annual interim period, respectively.

Rule 3-19(f) requires interim financial information that is made available to shareholders, exchanges or others on a more frequent basis than that required by Rules 3-19(b) and (c) to be included in any registration statement filed with the Commission. The rule requires this additional information to be reconciled to U.S. generally accepted accounting principles (GAAP). The proposed amendments would provide that if a registration statement includes interim financial information which is more current than the latest reconciled annual or semi-annual financial statements, the later financial information need not be reconciled to U.S. GAAP provided that any material variation in accounting which was not previously disclosed and quantified in the reconciliation for an annual or semi-annual period is described and the quantified effects of the material variation are disclosed.

Other amendments are proposed to: (1) Clarify language in Forms F-2 and F-3 to indicate that it is permissible to incorporate interim financial statements which may be filed on Form 6-K (which is not deemed filed otherwise); and (2) amend Rule 15d-2 to require foreign private issuers to file special year end financial statement reports (subsequent to the effectiveness of a registration statements for the most recent year end) by the later of 90 days following the effective date or six months following the registrant's fiscal year end. This would amend the current rule to recognize that foreign issuers are allowed up to six months following the end of the fiscal year within which to file their annual report including audited year end financial statements.

B. EDGAR (Electronic Data Gathering, Analysis and Retrieval)

On July 24, 1992, the Commission issued for public comment four releases that propose rules that would require most documents processed by the Divisions of Corporation Finance and Investment Management to be filed electronically by direct transmission, diskette, or magnetic tape. The releases (published in the Federal Register on August 27, 1992) also contain proposed phase-in schedules to bring registrants onto

the EDGAR system. Securities Act Rel. No. 6944 explains the EDGAR system and sets forth proposed rules and procedures that would apply to electronic submissions processed by the Division of Corporation Finance and in some cases, to those processed by the Division of Investment Management ("Corporation Finance Proposing Release"). See also Investment Company Act Rel. No. 8863; Public Utility Holding Act Rel. No. 25589; and Securities Act Rel. No. 6947 (concerning payment of filing fees to the Commission's lockbox). Comments on these releases should be received on or before October 6, 1992.

1. Background

a. EDGAR Pilot System

Development of an electronic disclosure system was undertaken by the Commission in 1983, and construction of a pilot system ("EDGAR Pilot") to develop and test an electronic system was commenced in May 1984. The first filings were received in the EDGAR Pilot on September 24, 1984, and through the closing of the EDGAR Pilot on July 14, 1992, the Commission received over 116,000 electronic filings from over 1800 filers.

b. Operational EDGAR System

Development and implementation of an electronic system was authorized as part of the Securities and Exchange Commission Authorization Act of 1987. In accordance with that authorization, on January 4, 1989, the Commission awarded a contract to build the operational EDGAR system to BDM International, Inc. Other parties to the contract include Mead Data Central Inc., Bowne & Company, Disclosure Information Services, Inc., and CompuServe, Inc.

On May 1, 1991, the operational EDGAR system was officially opened for test submissions by EDGAR Pilot participants. On July 15, 1992, the new EDGAR system began receiving live filings by Pilot participants and the Pilot was closed. In order to facilitate the transition of EDGAR Pilot participants to operational EDGAR ("Transitional Filers"), the Commission issued amended EDGAR Temporary Rules on April 20, 1992. (See Securities Act Rel. No. 6933.) The rule amendments were the minimum changes necessary to implement the transition, reflecting the different design features of the new system. Since Transitional Filers are volunteers, they may choose not to file electronically on operational EDGAR at any time and submit any

filings in paper format until mandated to file electronically.

The amended Temporary Rules and Forms, together with the EDGAR Filer Manual, will govern electronic filing until mandated electronic filing commences, currently anticipated to be in spring or summer 1993. After considering public comment on the proposed rules issued on July 24, 1992, but before mandated electronic filing commences, rules and forms governing operational EDGAR will be adopted. In addition, phase-in schedules reflecting any changes from those proposed on July 24, 1992, will be adopted.

2. Phase-In

Registrants whose filings are processed by the Division of Corporation Finance will be brought onto the EDGAR system in a series of discrete groups. Section 35A(c)(5) of the Exchange Act requires that mandated filings from a "significant test group" of registrants be received and reviewed by the Commission for at least six months before the final adoption of any rule requiring electronic filing by registrants. The "significant test group" will be phased in between April and December 1993, in four groups. Pilot participants will begin mandated filing in April 1993 in Group CF-01. The next group, Group CF-02, consisting of approximately 525 registrants whose filings are processed by the Division of Corporation Finance, will begin mandated electronic filing in July 1993. However, the Commission may allow a limited number of registrants, otherwise scheduled for mandated phase-in with the first non-Pilot group, (Group CF-02) to elect to begin their mandated filing in Group CF-01 in April 1993 with the Pilot participants. The third group (Group CF-03) and fourth group (Group CF-04) of the "significant test group" will consist of approximately 750 and 1000 registrants, respectively, whose filings are processed by the Division. These numbers do not include filers with the Division of Investment Management, to be phased in at the same time.

After the "significant test group" has successfully filed for at least six months, the Commission will adopt final EDGAR rules modified to reflect the experience gained during that period, together with a revised phase-in schedule, if necessary. Registrants will then be phased in, in groups of approximately 1500, every three months, (except for the first calendar quarter of every year), with any new

registrants or others not named in the phase-in schedule included in the last group phased in.

3. EDGAR Proposed Rulemaking, Major Areas

a. Regulation S-T

The cornerstone to the proposed EDGAR rules is Regulation S-T, which will be a separate regulation containing rules prescribing requirements for filing electronically and the procedures for making such filings. Examples of its coverage include identifying which filings must be filed electronically, the hardship exemption rules, and the graphic and image material rules.

b. Effect of EDGAR on Paper Filing Rules

Proposed Regulation S-T is designed as a supplement to the current paper rules, rather than as a replacement. Accordingly, a registrant that wants to amend a Securities Act registration statement, for example, would continue to look to the 470 series of Rules of Regulation C whether the registrant is filing electronically or on paper. However, where appropriate, existing rules would be modified to present an "electronic filing" paragraph in the rule. This new paragraph would be substantially identical to the current provisions, except that it may direct a filer's attention to applicable provisions of Regulation S-T such as the signature rules, or it may provide that certain provisions of the current rule, such as the requirement to file multiple copies, are not applicable to EDGAR.

Electronic filers that obtain an exemption from the electronic filing provisions of proposed Regulation S-T and filers that are not phased in would continue to file in paper in accordance with existing provisions of the Commission's regulations and forms. A few provisions relating to paper filings would be amended to ensure consistency of treatment between electronic and paper filings, for example, the treatment of annual reports to security holders; in general, however, the EDGAR rulemaking is procedural in nature and will not affect substantive requirements.

c. Mandatory, Excluded and Permissive Electronic Submissions

The proposed rules provide, with certain initial exceptions, that all documents, including filings,

correspondence, and supplemental information, submitted by or relating to registrants pursuant to the Securities Act, the Exchange Act and the Trust Indenture Act be submitted electronically in accordance with the phase-in schedule. Once phased in, a registrant would not be permitted to file in paper except: pursuant to a hardship exemption; if the registrant is filing a document that has been excluded from electronic filing, such as a Form T-4; if it is required to file a Schedule 13D or 13G relating to a registrant not yet phased in; or if it commenced a cash tender offer or proxy contest for a registrant not yet phased in. Once a registrant is required to file electronically, filings made by third parties, whether made by business entities or individuals, such as proxy materials, tender offer materials, and beneficial ownership materials would be required to be submitted electronically, absent a hardship exemption, as the status of the electronic registrant controls.

Filings and other documents filed by or relating to a registrant required to file in paper generally would not be permitted to file electronically. Exceptions would be provided for joint registration statements involving electronic and paper registrants; filings relating to cash tender offers or proxy contests involving a paper bidder and an electronic target; mergers, exchange offers and other business combinations involving a Securities Act registration statement filed by a paper filer seeking to acquire an electronic target; and cash mergers involving a joint proxy statement filed by a paper and an electronic filer. In these circumstances, the status of the electronic filer would control, requiring the bidder or acquiror to make filings relating to the particular transaction in electronic format, absent a hardship exception.

Certain documents will not be filed in electronic format, such as Regulation B filings. Forms 3, 4, 5 and 144 will not be filed initially on EDGAR, although it is anticipated that EDGAR will be enhanced to accept these filings once phase-in is completed. Other filings that will be excluded include confidential treatment applications; interpretive, no-action and exemptive requests; and shareholder proposal filings. These documents are being excluded from electronic filing at this time so as not to divert Commission resources from other areas of the EDGAR system.

Until the period for successful filing by the "significant test group" has been concluded, no

volunteers will be permitted to file on EDGAR in order to assure that the Commission has sufficient filer support staff to answer questions and provide assistance to phased in electronic filers. After that, during the remainder of the phase-in, the Commission may permit subsidiaries of a parent filing on EDGAR, foreign issuers, and others to file electronically.

Once permitted to file on EDGAR, volunteers would be subject to the same rules as mandated electronic filers and would not be permitted to make required filings in paper except pursuant to a hardship exemption. After the phase-in, consideration will be given as to what extent, if at all, foreign issuers would be required to file on EDGAR.

d. Hours of Operation/Date of Filing

The hours of operation, as in the EDGAR Pilot, are 7:30 a.m. to 7:00 p.m. Eastern Time. Once mandated filing commences, magnetic tapes and diskettes would be accepted for filing during the Commission's current hours for receipt of paper filings, namely, 8 a.m. to 5:30 p.m. Eastern Time. Direct transmission filers would be permitted to transmit until 10 p.m. Eastern Time, but any direct transmission filing that commenced after 5:30 p.m. Eastern Time, if accepted, would be considered filed as of the next business day, except for a Schedule 13D or specified tender offer filings, which would be considered filed on that business day only if accepted by 5:30 p.m. Eastern Time.

e. Signatures and Exhibits

The amended Temporary Rules as well as the proposed rules provide for the use of typed signatures for all signatories, including experts, no matter which means of transmission is used. "PIN" numbers, used in the EDGAR Pilot, are not required by Operational EDGAR.

Generally, under the proposed rules, exhibits filed in paper prior to the time the filer becomes subject to mandated electronic filing would not have to be refiled in electronic format. Once the filer becomes subject to mandated electronic filing, any new exhibits would have to be filed in electronic format, absent a hardship exemption. Further, the first amendment to an exhibit previously filed in paper either would have to restate the exhibit to which it relates in its entirety or the amendment and the exhibit to which it relates would have to be filed in electronic format absent a hardship exemption. For example, where a material

contract that was initially filed in paper must be amended electronically because the registrant becomes subject to the electronic filing requirements subsequent to filing the material contract but prior to filing the amendment, the proposed rules would provide that either the material contract would have to be filed in its entirety in electronic format or the amendment and the material contract would have to be filed in electronic format, absent a hardship exemption.

f. Hardship Exemptions/Adjustment of the Filing Date

Proposed Regulation S-T includes three provisions to address difficulties in the electronic submission of documents: a temporary hardship exemption; a continuing hardship exemption; and an adjustment of the filing date. A temporary hardship exemption rule would provide relief to an electronic filer that is temporarily unable to submit a document in electronic format. The exemption may be appropriate, for example, for a particular document that a filer is unable to file electronically due to a storm that interrupts power to the filer's area or problems with the filer's computer equipment that had been used previously to transmit either test or required electronic filings successfully. To obtain this exemption, a filer would be required to undertake to file a copy of the document in electronic format within three business days of filing the document in paper format.

A continuing hardship exemption would provide relief to electronic filers without requiring a follow-up electronic copy. The use of this exemption might be appropriate for filings of a company that is under the protection of a bankruptcy court where electronic filing may be burdensome or for voluminous material contracts of an acquired company, the conversion which would present undue hardship to the acquiror. The grant of these exemptions will be circumscribed as narrowly as possible, as they will affect the completeness of the electronic database.

Finally, a filer could seek an adjustment of the filing date for an electronic format document. An adjustment may be appropriate, for example, where a filer had begun transmitting a Form 10-K on or before 5:30 p.m. on the due date of the Form 10-K, but the filer's transmission was interrupted due to technical electronic difficulties beyond its control and the direct transmission recommenced after 5:30 p.m.

While the foregoing hardship exemptions do not apply to Transitional Filers since they are volunteers, they are able to request an adjustment of their filing date as in the EDGAR Pilot.

g. Safe Harbor

Given concerns expressed about the possibility of an undetected error or omission resulting from the electronic transmission of a filing on EDGAR, the proposed rules include a safe harbor, which provides that an electronic filer would not be subject to the liability and anti-fraud provisions of the federal securities laws with respect to an error or omission in a document resulting solely from the good faith transmission of such document via EDGAR, whether by magnetic tape, diskette or direct transmission. The safe harbor would be conditioned upon correction of the error or omission no more than five business days after the registrant becomes aware of the error or omission.

h. Paper Copies

The EDGAR Authorization Act requires all electronic filers, for the first year in which they become mandatory electronic filers (or such shorter period that the Commission determines is appropriate), to submit paper copies of their electronic filings submitted via EDGAR. Accordingly, Regulation S-T would provide that all filers making any filings on EDGAR would be required to furnish the Commission with paper copies of their filings for a one-year period after becoming phased in or until expressly notified otherwise by the Commission. Either computer print-outs of EDGAR filings or the traditional paper filings would be acceptable. Also, timing requirements would be such that the paper copies may be mailed in to the Commission. As Transitional Filers are volunteers, they will not be required to submit copies of their paper filings until phase-in begins.

i. Modular Submissions/Segmented Filings

A modular submission procedure, which is currently available to Transitional Filers, allows electronic filers to submit information that is intended to become a part of more than one filed document to a non-public EDGAR data storage area and then transfer the information to as many official electronic filings, as desired. For example, a registrant could use the modular submission procedure to file its description of business as one modular document, description of property as a second modular document, audited year-end financial statements and management's discussion and analysis as a third modular document, disclosure on directors, executive officers and control persons as a fourth modular document and exhibits as a fifth modular document. The registrant could then file a Form S-1 registration statement which instructs the EDGAR system to insert each of the five modular documents into specified places in the Form S-1. With respect to its annual proxy statement, the registrant could request that only the directors, executive officers, and control persons disclosure module be included in a specified location in the proxy statement.

It is anticipated that once phase-in begins, segmented filing will be available. Segmented filing would permit different parts of a filing to be sent at different times over a period of a few days, and then joined to become an official filing. Unlike modular documents, the segments could not be re-used in subsequent filings. For example, voluminous exhibits could be sent in advance of a filing.

j. Graphic and Image Material

No cost-effective and efficient technology is currently available to process graphic and image material in EDGAR. While means of obtaining graphics on EDGAR in the future continue to be explored, the amended Temporary Rules and proposed graphic and image rules address the treatment of pictures, charts, etc. whether required by the Commission's rules or submitted at the option of the filer. The rules do not permit the material to be filed in paper except pursuant to a hardship exemption in order to keep the database as complete as possible; rather, they provide that an appendix to electronic format documents must refer to any omitted graphic and image material. If substantive information conveyed by the omitted graphic material is separately presented in narrative form in the body of

the electronic format document, the appendix would simply list the graphic and image materials omitted from the paper version of the document. For example, a chart showing "Sources of Revenue" might be omitted from an electronic document, but if the sources of revenue were separately discussed in the document, e.g., in the management's discussion and analysis section, then the chart would simply be listed in an appendix to the document, entitled "Omitted Graphic and Image Materials." Otherwise, the appendix would be required to list the omitted graphic materials and also provide a fair and accurate narrative description of such materials. Unlike the EDGAR Pilot requirements, the amended Temporary Rules and the proposed rules do not require electronic filers to describe differences relating to corporate logos, pagination, color, or type size and style.

k. Annual Reports to Security Holders

Since graphic and image material is often included in the annual report to security holders ("glossy report"), the proposed rules would relieve both paper and electronic filers from the obligation to send copies of their glossy reports to the Commission if their Form 10-K reports include all of the information required to be disclosed in the glossy report. This is one of the few rule changes affecting paper as well as electronic filers. If the Form 10-K does not include all of the required disclosure, registrants would continue to be subject to the requirement to furnish a copy of their glossy reports to the Commission in paper or electronic format depending on the status of the registrant. This proposed approach would neither change the role of glossy reports as documents providing information directly to security holders, nor alter the option of incorporating by reference the glossy report, or portions thereof, into certain filings, such as Form S-2. If, however, a glossy report, or portion thereof, is incorporated by reference into a document, then the proposed rules would require that the complete glossy report be filed electronically with the Commission.

l. Financial Data Schedule

One of the principal benefits to EDGAR is the ability to obtain financial and statistical information in filings. In order for EDGAR to recognize and extract such information, the information must be tagged in a specified manner. In order to provide the system with the capability to identify financial information, the

proposed rules would require all EDGAR registrants to file a Financial Data Schedule with the Commission pursuant to Item 601 of Regulation S-K once phased in. The Financial Data Schedule would set forth specified financial information from the registrant's financial statements, schedules and other disclosure requirements such as industry guides. Unlike the EDGAR Pilot, this information would be available to the public. The proposed Financial Data Schedule provides a means whereby specific numbers taken from a registrant's existing financial statements, schedules and disclosures made pursuant to applicable industry guides are placed into a formatted schedule and identified with data tags, computer-recognizable labels, which permits the data to be read and analyzed by EDGAR. For example, numbers representing a registrant's total current assets and total current liabilities for its last fiscal year, when placed in the Financial Data Schedule, would be recognized by EDGAR and working capital could be calculated automatically. Financial Data Schedules, which Pilot Filers referred to as "data tagging," will not be required from Transitional Filers prior to mandated electronic filing.

C. Small Business Initiatives

On July 29, 1992, the same day that the Commission adopted revisions to the rules and forms under the Securities Act, Exchange Act, and Trust Indenture Act to facilitate capital raising by small businesses and reduce the compliance burdens placed on these companies (Securities Act Release No. 6949), the Commission published for comment additional revisions to further factilitate financings by small business issuers (Securities Act Release No. 6950). See Section I. A. of this outline for further details.

III. Other Accounting and Disclosure Issues of Current Interest

A. Accounting and Disclosure Issues Regarding Debt Securities

In response to changes in financial markets that have occurred over the last several years, some banks, thrifts, insurance companies and other registrants have changed their policies with respect to the management of their investment portfolios, resulting in significant sales of debt securities out of the portfolios. These registrants should consider the effect that a change in portfolio management practices may have on the accounting policy applicable to the

portfolio. In particular, the amortized cost method of accounting for debt securities may not be appropriate after adoption of the new portfolio management policy.

To qualify for use of amortized cost accounting for investment securities, existing authoritative literature requires an intent and the ability to hold securities on a long-term basis or until maturity. If management lacks that intent, securities should be classified as available for sale or as trading securities. The staff will challenge registrants who make significant sales of investment securities or whose investment policy footnote identifies a practice that entails responding to changes in interest rates, prepayments, and similar economic factors that may be reasonably expected to result in sales of investment securities prior to maturity.

In such instances, the staff typically will request a revision to the financial statements to classify securities that will be held for indefinite periods of time as available for sale and to account for such securities at the lower of cost or market value. A revision of the investment policy footnote may also be required to clarify that securities held for indefinite periods of time, including securities that management intends to use as part of its asset/liability strategy, or that may be sold in response to changes in interest rates, prepayments, regulatory capital requirements or other similar factors are classified as held for sale and carried at lower of cost or market value. Additional clarification that investment securities are carried at amortized costs because of the registrant's ability to hold such securities to maturity, and the intent of management is to hold such securities on a long-term basis or until maturity may also be required. Management's Discussion and Analysis and other textual disclosures should be revised to be consistent with the accounting policy.

With respect to debt securities that continue to be accounted for at amortized costs, the staff routinely requests the following disclosures by banks, savings and loans, thrifts, finance companies, insurance companies and similar institutions.

* The accounting policy note to the financial statements should clearly identify the characteristics that must be present for the institution to carry a security at amortized cost, rather than at market or lower of cost or market.
* Market value of the portfolio should be disclosed on the face of the balance sheet.

* Gross unrealized gains, gross unrealized losses, cost and market value should be disclosed for each pertinent category of debt securities in a note to the financial statements.
* Proceeds from the sales of securities should be distinguished from the proceeds of maturities in the cash flow statement or in a note thereto.
* Gross realized gains and gross realized losses on sales of securities should be separately disclosed in the MD&A. Disclosure in the financial statements is recommended.
* For the most recent balance sheet, the amortized cost and market value of securities due in one year or less, after one year thru five years, after five years thru ten years, and after ten years should be disclosed.
* MD&A should analyze and, to the extent practicable, quantify the likely effects on current and future earnings and investment yields and on liquidity, capital resources and regulatory compliance of: material unrealized losses in the portfolio; material sales of securities at gains; material shifts in average maturity. A similar analysis should be provided if a material portion of fixed rate mortgages maturing beyond one year carry rates that are below current market.
* If sales out of the portfolio were significant, the MD&A should describe those events unforeseeable at earlier balance sheet dates that caused management to change its investment intent.
* If a material proportion of the portfolio consists of securities that are not actively traded in a liquid market, MD&A or Business Description should include disclosure of the proportion and describe the nature of the securities and the source of market value information used for the financial statements. MD&A should include discussion of any material risks associated with the investment relative to earnings and liquidity. Similar disclosure should be furnished if the portfolio includes instruments the market values of which are highly volatile relative to small changes in interest rates and this volatility may materially affect operating results or liquidity.
* Investments available for sale, categorized by types of investments, should be presented separately from the balance of the investment portfolio in Table II, "Investment Portfolio", of Industry Guide 3 data. Contractual maturities of investments held for sale need not be presented.

B. "Other Than Temporary" Declines in Value of Debt and Equity Marketable Securities

Recently, the staff has challenged a number of registrants regarding the need to recognize and properly account for declines in the value of marketable securities that are other than temporary. FAS 12, the Codification of Auditing Standards (AU 9332), and other literature applicable to specific industries require recognition of declines in market value of debt and equity securities if the decline is "other than temporary". For example, see AAER 309, Fleet/Norstar Financial Group, Inc. (August 14, 1991).

If the decline reflects the market's perception of "specific adverse conditions" affecting a particular security, a write down to net realizable value is always required. Further, SAB 59 (Topic 5:M) advises that if the market price is affected by general market conditions which reflect prospects for the economy as a whole or of a particular industry, management should act upon the premise that a write down is required. SAB 59 identifies factors that should be considered in evaluating whether the decline is other than temporary.

If the decline is other than temporary, a write down to net realizable value is required. SAB 59 acknowledges that the "particular facts and circumstances dictate the amount of realized loss to be recognized on a case by case basis." Market price reflects the market's evaluation of the total mix of available information about a security. Objective evidence is required to support a realizable value in excess of a contemporaneous market price. Registrants should employ a systematic methodology ensuring that all available evidence concerning the declines in market value will be identified. The specific rationales and evidence supporting the realizable values of securities that have experienced market value declines should be documented.

The magnitude and duration of unrecognized market value decline are key factors weighed by the staff in its evaluation of the need to challenge a registrant's accounting for marketable securities. However, with respect to debt securities, declines in value that are attributable to the market's expectations regarding inflation and general interest rates would not be challenged so long as the registrant has the ability and intent to hold the security to maturity.

Consideration should be given to the intent and ability to retain an investment for a period of time sufficient to allow for anticipated recovery. However, as the period of time necessary for any forecasted recovery to occur lengthens, so do uncertainties inherent in assumptions underlying such recovery. Recoveries that cannot be reasonably expected to occur within a reasonable forecast period should not be considered in the assessment of realizable value.

C. Accounting and Disclosures Involving Lending Activities

A registrant engaged in significant lending activities should furnish information about its loan portfolio that is substantially similar to that customarily furnished by banks. In particular, registrants should consider the quantitative disclosures described in Sections III and IV of Industry Guide 3. This information includes loans by pertinent category, maturities, concentrations, risk elements, loan status and loss experience for a five-year historical period. Registrants are cautioned not to overlook disclosure of "potential problem loans" that are not otherwise required to be disclosed but involve problems which cause management to have serious doubts as to the ability of the borrowers to comply with loan terms. Registrants should also consider the updating requirements of General Instruction 3(d) to the Industry Guide. In addition, notes to the financial statements should identify the circumstances under which accrual of interest on a loan is ceased, and amounts of interest that have not been accrued in accordance with loan terms should be disclosed.

If an unusually large provision for loan losses is reported in a quarter, registrants should discuss in the MD&A those factors which arose in the reporting period that caused management to materially reduce its estimate of amounts ultimately realizable from outstanding loans.

Lenders in all industries should follow the guidance in FRR 401.09c regarding the accounting for substantively foreclosed assets. Collateral should be accounted for as substantively foreclosed if the debtor has little or no equity in the collateral (considering its current fair value), loan repayment can be expected to come only from the collateral, and it is doubtful that the debtor will rebuild equity in the collateral in the foreseeable future. Foreclosed collateral should be recorded at the lower of the loan's carrying amount or the collateral's fair value (discussed below) at the

date of foreclosure, establishing a new cost basis for the property. Any excess of the carrying amount over fair value at that date should be recorded as a loss. Thereafter, the accounting principles for assets held for sale should normally be followed. Registrants should note that fair value, as defined by FASB 15, is the amount that the creditor could reasonably expect to receive for the asset in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. The adoption of strategies (such as a hold-for-the-future strategy that is based on expectations of future price increases, or a strategy of operating the repossessed collateral for one's own behalf) cannot justify use of derived accounting valuations that portray results of operations more favorably than would use of current values in active markets.

D. Accounting and Disclosures for Letters of Credit

Letters of credit are a class of financial instruments for which disclosures are necessary pursuant to FAS 105. That standard requires disclosure of credit risk arising from letters of credit, measured as the amount of accounting loss the entity would incur if any party to the instrument failed completely to perform according to the terms of the contract and any collateral proved to be of no value. A brief description of any collateral supporting the instruments is required, along with related disclosures. Group concentrations of the credit risk arising from letters of credit also must be disclosed pursuant to FAS 105. Groups of similarly affected credit risks for which disclosure is commonly required in Commission filings are identified in Section III.A. of the Industry Guide for banks, although registrants also should consider the guidance of Section III.C.(4) of that Guide.

The staff believes that a letter of credit may represent an actual and/or potential problem loan for which disclosures are required pursuant to Section III.C. of the Guide if amounts funded under the instrument are not recovered pursuant to its terms, or if management has serious doubts regarding the ability of the party to perform fully in accordance with the instrument's terms. Further, the staff believes that funded amounts of letters of credit included in disclosures required by Section III.C. should be accompanied by explanation regarding any additional commitments under the instruments. If material, allowances for losses on letters of credit and similar

off balance sheet items should be presented as a liability rather than included in the allowance for loan losses, and off-balance sheet loss provisions should not be included in arriving at net interest income.

The staff also believes that the guidance in FRR 28 regarding substantively foreclosed loans applies to letters of credit. Consistent with that view, the recognition of a loss on a collateralized letter of credit must be based on the excess of the commitment under the agreement over the fair value of the collateral when the criteria in FRR 28 are met.

E. Disclosures Regarding Risks Associated With Real Estate

If a significant portion of a registrant's operations involve developing, operating or otherwise investing in real estate or making loans collateralized by real estate, the description of the registrant's business in filings with the Commission should include information regarding the registrant's policies and practices with respect to selection of properties (types, locations, concentration limits), and assessments of impairments (frequency of appraisals, source of appraisals, methodologies employed, etc.). Notes to the financial statements should clearly describe the registrant's accounting policies with respect to the carrying value of real estate assets: the circumstances under which an impairment is be recognized, the elements entering into the measurement of the asset's net realizable value, and the procedure for adjusting carrying value (ie., direct write-off or allowance, individual or portfolio basis).

In the MD&A, registrants should discuss how known trends, events or uncertainties may materially affect liquidity or results of operations, including discussion of the following, as applicable: significant debt payments or other funding commitments that will become due, capital requirements of planned development or refurbishment activities, trends in occupancy and rental rates, declining real estate values, changing interest rates, uncertainties underlying management's estimates of net realizable value, risks inherent to particular concentrations, etc. If real estate properties are carried in the financial statements at amounts that materially exceed current market prices, this should be disclosed and quantified, and the reasons for not recognizing any present impairment should be explained.

Financial information about real estate ventures and partnerships accounted for on the equity method may be necessary: full financial statements are required in all filings (except in annual reports to shareholders) if the investee is significant at the 20% level or greater pursuant to Rule 3-09; if the investees are significant individually or in the aggregate at the 10% level, only summarized financial information is required pursuant to Rule 4-08(g).

Registrants should be aware also of requirements to provide separate financial statements of real estate operations collateralizing significant loans pursuant to SAB 71:

* Acquisition, development and construction (ADC) loans: If over 10% of offering proceeds (or total assets, if greater) have been or will be invested in an single acquisition, development, and construction loan, financial statements of the property securing the loan should be provided in '33 Act filings. Also, where no single loan exceeds 10%, but the aggregate of such loans exceed 20%, a narrative description of the properties and arrangements is required. In '34 Act reports, the requirement for full financial statements is triggered at the 20% level, but summarized information is required at the 10% level.
* Other loans: If over 20% of offering proceeds (or total assets, if greater) have been or will be invested in a single loan (or in several loans on related properties to the same or affiliated borrowers), financial statements of the property securing the loan are required in '33 and '34 Act filings.

F. Environmental and Product Liability Loss Contingencies

The staff believes that it is the responsibility of management to accumulate on a timely basis sufficient relevant and reliable information to make a reasonable estimate of its probable liability. Notwithstanding significant uncertainties, management may not delay loss accrual until only a single amount can be reasonably estimated. If management is able to determine that the amount of the liability is likely to fall within a range and no amount within the range can be determined to be the better estimate, the registrant should record the minimum amount of the range pursuant to FIN 14.

The measurement of a liability for environmental clean-up should be based on currently enacted laws and regulations and on existing technology. A registrant should consider all available evidence including the

registrant's prior experience in cleaning up contaminated sites, other companies' experience, and data released by EPA. The staff believes information necessary to support a reasonable estimate or range of loss may be available prior to the performance of any detailed remediation study. Estimates of costs associated with alternative remediation strategies may provide a reasonable basis to recognize a minimum probable loss.

Loss accruals established by some registrants have been reported net of expected recoveries from insurance carriers or other third parties. Recent litigation over insurance coverage and financial failures in the insurance industry indicate there may be significant uncertainties associated with estimated recoveries. Since the risks and uncertainties associated with the liability are different from those associated with any potential recovery from third parties, the staff believes that the liability and the recovery should be evaluated independently and disclosed separately either on the face of the balance sheet or in a note to the financial statements. Information necessary to an understanding of material uncertainties affecting both the measurement of the liability and the realization of recoveries should be furnished. This may include the following: the extent to which unasserted claims are reflected in any accrual or may affect the magnitude of the contingency; the extent to which joint and several liability with other parties may affect the magnitude of the contingency; the extent to which disclosed but unrecorded contingent losses are subject to recovery through insurance; the extent to which insurance coverages are subject to dispute; and the effects on the company's liquidity and capital resources of expected expenditures in light of the expected timing of reimbursement by third parties.

Registrants may succeed to a material contingent liability as a result of a business combination. If the registrant is awaiting additional information necessary for the measurement of a contingency of the acquired company during the allocation period specified by FAS 38, the registrant should disclose that the purchase price allocation is preliminary. In this circumstance, the registrant should describe the nature of the contingency and furnish other available information which will enable a reader to understand the magnitude of any potential accrual and the range of reasonably possible loss. Discussion of the contingency is likely to be warranted in MD&A.

G. Disclosures Regarding the Realization of a Deferred Tax Asset Recognized Pursuant to SFAS 109

SFAS 109 ("Accounting for Income Taxes") requires recognition of future tax benefits attributable to tax net loss carryforwards and deductable temporary differences between financial statement and income tax bases of assets and liabilities. Deferred tax assets must be reduced by a valuation allowance if, based on the weight of available evidence, it is more likely than not that some portion or all of the benefits will not be realized. Notes to financial statements must disclose the amount of the valuation allowance and changes therein. If a registrant has recognized a net deferred tax asset that is material to stockholders equity, it may be necessary to discuss uncertainties surrounding realization of the asset and material assumptions underlying management's determination that the net asset will be realized. If the asset's realization is dependent on material improvements over present levels of consolidated pre-tax income, material changes in the present relationship between income reported for financial and tax purposes, or material asset sales or other nonroutine transactions, a description of these assumed future events, quantified to the extent practicable, should be furnished in the MD&A. For example, the minimum annualized rate by which taxable income must increase during the tax NOL carryforward period should be disclosed if realization of the benefit is dependent on taxable income higher than currently reported. Also, if significant objective negative evidence indicates uncertainty regarding realization of the deferred asset, the countervailing positive evidence relied upon by management in its decision not to establish a full allowance against the asset should be identified.

H. Take-or-Pay Obligations of Gas Pipelines

Gas pipeline companies subject to take-or-pay obligations should provide sufficient information to enable an investor to understand the magnitude of the commitment and the nature and extent of uncertainties bearing upon the obligation's ultimate effect on future operations and liquidity. These disclosures typically include: (a) the registrant's accounting policies governing the provision for losses attributable to unfavorable pricing commitments and for current and potential claims under the contracts; (b) disclosure of the total dollar amount of suppliers' asserted and unasserted claims for deliveries not taken under take-or-pay contracts and for deliveries taken but for which

the settlement amount is disputed; and (c) a schedule of commitments for each of the next five years and thereafter, in dollars, under contracts not having variable, market-based pricing, accompanied by an explanation of the extent to which provisions have been made for unfavorable pricing. Other information may be required if a material oversupply situation is reasonably possible.

In addition, the staff believes any liability recognized in connection with its take-or-pay obligations and related litigation should not be reported net of probable future revenues resulting from the inclusion of such costs in allowable costs for rate-making purposes. Costs meeting the criteria of paragraph 9 of FAS 71 should be presented on the balance sheet as a regulatory asset and should not be offset against the liability. Contingent recoveries through rates that do not meet the criteria of paragraph 9 should not be recognized either as an asset or as a reduction of the probable liability.

I. Management's Discussion and Analysis - Recent Enforcement Action

The Commission announced that on March 31, 1992, administrative proceedings under the Exchange Act were instituted against Caterpillar Inc. ("Caterpillar") for violations of Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 promulgated thereunder. Simultaneously with the institution of these proceedings, the Commission accepted Caterpillar's Offer of Settlement in which it consented to the entry of a Cease and Desist Order. (Rel. No. 34-30532).

The Commission determined that Caterpillar failed to adequately disclose the importance of its Brazilian subsidiary's 1989 earnings to Caterpillar's overall results of operations in the MD&A portion of Caterpillar's 10-K for the year ended December 31, 1989. The Commission also determined that Caterpillar failed to adequately disclose known trends and uncertainties regarding its Brazilian operations in its 1989 10-K and in its Report on Form 10-Q for the quarter ended March 31, 1990.

The Commission's Order requires Caterpillar to cease and desist from violating Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder, and implement and maintain procedures designed to ensure compliance with the MD&A requirements.

The Commission previously issued an interpretive release (Rel. No. 33-6835; May 18, 1989) on MD&A (Item 303 of Regulation S-K). The release sets forth the Commission's views regarding several disclosure matters that should be considered by registrants in preparing MD&As. The release emphasized the distinction between prospective information that is required to be disclosed, and voluntary forward-looking disclosure. The release states that if there is a known trend, demand, commitment, event or uncertainty, management must make two assessments to determine what prospective information is required.

First management must determine whether the known trend, demand, commitment, event or uncertainty is likely to come to fruition. If management determines that it is not reasonably likely to occur, no disclosure is required.

Second, if management cannot make the determination that the event is not likely to occur, it must evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty, on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the registrant's financial condition or results of operations is not reasonably likely to occur. Each final determination resulting from the assessments made by management must be objectively reasonable, viewed as of the time the determination is made. The release clarifies that the safe harbor rules apply not only to voluntary forward-looking statements, but also to prospective information that is required to be disclosed.

The release also provides interpretive guidance regarding the following matters: long and short-term liquidity and capital resources analysis; material changes in financial statement line items; required interim period disclosure; MD&A analysis on a segment basis; participation in high yield financing, highly leveraged transactions or non-investment grade loans and investments; the effects of federal financial assistance upon the operations of financial institutions; and preliminary merger negotiations.

J. Disclosures about Foreign Operations and Foreign Currency Transactions

An increasing number of registrants conduct material operations outside their home country and enter into material transactions denominated in currencies other

than the currency in which their financial statements are reported. These registrants should review management's discussion and analysis and the notes to financial statements to ensure that disclosures are sufficient to inform investors of the nature and extent of the currency risks to which the registrant is exposed and to explain the effects of changes in exchange rates on its financial statements. SFAS 14 requires quantitative disclosures regarding export revenues and foreign operations. MD&A should include discussion of the historical and reasonably likely future effects of changes in currency exchange rates on revenues, costs, and business practices and plans. Identification of the currencies of the environments in which material business operations are conducted is recommended. Discussion of foreign operations in a disaggregated manner may be necessary, particularly with respect to businesses operating in a highly inflationary environment or if operating cash flows of a foreign operation are not available for legal or economic reasons to meet the registrant's other short term cash requirements. Registrants also should quantify the extent to which trends in amounts reported in their financial statements are attributable to changes in the value of the reporting currency relative to the functional currency of the underlying operations, and any materially different trends in operations or liquidity that would be apparent if reported in the functional currency should be analyzed. Finally, registrants should identify material unhedged monetary assets, liabilities or commitments denominated in currencies other than the operation's functional currency, and strategies for management of currency risk should be described.

K. Disclosures about New Accounting Standards

1. Before Adoption by the Registrant

Staff Accounting Bulletin 74 (Topic 11:M) discusses disclosures that a registrant should provide in its financial statements and/or in management's discussion and analysis regarding the impact that recently issued accounting standards will have on its financial statements when the standard is adopted in a future period. Disclosures that should be considered include a brief description of the standard and its anticipated adoption date, of the method by which the standard will be adopted, of the impact that the standard will have on the financial statements to the extent reasonably estimable, and of any other effects that are reasonably likely to occur (eg., changes in business practices,

changes in availability or cost of capital, violations of debt covenants, etc.). In this regard, registrants should consider the effects of not only standards recently issued by the FASB, but also Statements of Position and Practice Bulletins issued by the AICPA and consensus positions of the EITF.

2. Adoption of New Standard in Interim Period

Rule 10-01(a)(5) of Regulation S-X permits registrants to omit from interim reports on Form 10-Q footnote disclosures that would be repetitive of information included in the annual financial statements, except that disclosures about material contingencies must always be furnished. The rule also indicates that if events occur subsequent to the fiscal year-end, such as a change in accounting principles and practices, informative disclosure shall be made. Registrants should describe the accounting change and its impact pursuant to paragraph 23 of APB 28. In addition, the staff believes the interim financial statements should include, to the extent applicable, any specific disclosures which are identified by the adopted standard as required to be included in annual financial statements. If the change in accounting principle is made in a period other than the first quarter of the year, no amendment of prior filings is required; however, a restatement of each of the prior quarter's results should be included in the filing for the quarter in which the new accounting principle is adopted.

IV. Frequent Inquiries Regarding Application of Regulation S-X and Other Disclosure Practices

A. Financial Statements of Businesses Acquired (Rule 3-05)

1. Definition of a business. Identified by evaluating whether there is sufficient continuity of operations so that disclosure of prior financial information is material to an understanding of future operations. (See Rule 11-01(d) of Regulation S-X.) There is a presumption that a separate entity, subsidiary, or division is a business; a lesser component may be a business, too. Consideration should be given to --
   * whether the nature of the revenue producing activity will remain generally the same;
   * whether the facilities, employee base, distribution system, sales force, customer

base, operating rights, production techniques, or trade names remain after the acquisition.

2. Tests of Significance. Rule 1-02.v. describes three tests of significance that must be applied to determine the level at which an acquisition is significant for purposes of determining the number of years for which financial statements of the acquiree are required. Significance of the acquiree is determined by comparing the most recent pre-acquisition annual statements of the acquired business to the registrant's pre-acquisition consolidated statements as of the end of the most recently completed fiscal year for which audited financial statements are filed with the Commission.

   a. For a combination accounted for as a purchase, compare registrant's investment in (or consideration paid for) acquiree and advances to (including loans and receivables) to registrant's consolidated assets;
      (1) Contingent consideration should be considered as part of the total investment in the acquiree unless its payment is deemed remote.

   b. For a pooling or reorganization, compare the number of shares exchanged to registrant's outstanding shares immediately before combination;

   c. Compare registrant's share of acquired entity's total assets to the registrant's consolidated assets;

   d. Compare registrant's equity in the acquired entity's income from continuing operations before taxes to that of registrant.
      (1) If registrant's income for the most recent fiscal year is 10% or more lower than average of last five fiscal years, average income of the registrant may be used for this computation. Loss years should be assigned value of zero in computing numerator for this average, but denominator should be "5". This rule is not applicable if the registrant reported a loss, rather than income, in the latest fiscal year. The acquiree's

income may not be averaged pursuant to this rule.

e. Other guidance:

(1) If the aggregate of all "insignificant" businesses exceed 20% in any condition above, financial statements for the majority (combined if appropriate) should be furnished for most recent fiscal year and the latest interim period preceding the acquisition.

(2) If the acquisition was consummated shortly after the most recent fiscal year and the registrant files its Form 10-K for that year before the due date of the Form 8-K (including the 60 day extension), significance may be evaluated relative to that fiscal year.

(3) If the registrant has previously made a significant acquisition and it was fully reported on Form 8-K, significance test may be applied to that pro forma data rather than historical pre-acquisition data. The acquired business for which the test is made is not considered part of the registrant's base in determining significance.

(4) If a registrant increases its investment in a business relative to the prior year, the tests of significance should be based on the increase in the registrant's proportionate interest in assets and net income during the year, rather than the cumulative interest to date.

(5) Significance should be evaluated on basis of U.S. GAAP, rather than the foreign GAAP of the acquirer or acquiree.

(6) Ordinary receivables not acquired should nevertheless be included in tests of significance on the theory that working capital will be required after the acquisition.

(7) Registrant's assets may not be increased by pro forma effect of anticipated public offering proceeds for purposes of significance tests.

f. Registrants may request DCAO interpretation in unusual situations or relief where strict application of the rules and guidelines

results in a requirement that is unreasonable under the circumstances.

3. Division or Lesser Component Acquired.

The staff may accept audited statements of assets and liabilities acquired and revenues and expenses directly related to the business where the registrant can demonstrate that it is impracticable to prepare the full financial statements required by Regulation S-X, and the registrant includes this explanation in the filing. Unallocated items (corporate overhead, interest, taxes) may be excluded from these statements, but the amounts expected after the acquisition should be reflected in the pro forma statements.

4. Special Rule Applicable to an IPO

SAB 80 (Topic 1:J) is an interpretation of Rule 3-05 for application in the case of initial public offerings involving businesses that have been built by the aggregation of discrete businesses that remain substantially intact after acquisition. The guidance is intended to ensure that the registration statement include not less than three, two and one year(s) of audited financial statements of not less than 60%, 80% and 90%, respectively, of the constituent businesses that will comprise the registrant on an ongoing basis.

B. Acquisitions Involving Troubled Financial Institutions

If a bank or S&L is acquired in a federally assisted transaction and constitutes a business having material continuity of operation after the acquisition, the staff will not object to the omission of audited financial statements required by Rule 3-05 if the statements are not reasonably available and total assets of the acquired entity do not exceed 20% of the registrant's precombination total assets. Waivers will be considered for more significant acquisitions. Requests for waivers should be directed to DCAO. Additional disclosures are required when waivers are granted. See SAB Topic 1.K. (SAB 89).

Some entities have been formed recently for the purpose of acquiring operating real estate properties from the RTC. In certain circumstances, the auditor is unable to express an opinion on the financial statements

required by Rule 3-14 because the RTC will not provide the letter of representations deemed necessary. The registrant may request relief from DCAO. The staff generally will not object if the registrant's undertaking to furnish audited financial statements of properties acquired during the distribution period (Item 20 of Industry Guide 5) clearly states that audited financial statement of some properties acquired from the RTC may not be available, and appropriate risk disclosure is made. The statement of operations must otherwise comply with Regulation 3-14, but may be unaudited for the period of RTC ownership. The registrant's management must take appropriate steps to establish the reasonableness of the information underlying the unaudited statements, and should include other disclosures that facilitate investors' understanding of the status and prospects of the distressed property.

C. Financial Statements Relating to Third Party Credit Enhancements

Third party credit enhancements differ slightly from guarantees. A guarantee running directly to the security holder is a security within Section 2(1) of the Securities Act. A guarantor is a co-issuer under the Securities Act and provides required business and financial information and signs the registration statement. A third party credit enhancement is an agreement between a third party and the issuer or a trustee. A party providing credit enhancement generally is not a co-issuer. However, if an investor's return is materially dependent upon the third party credit enhancement, the staff requires additional disclosure. The disclosure must provide sufficient information about the third party to permit an investor to determine the ability of the third party to fund the credit enhancement. In most cases, the third party's audited financial statements presented in accordance with generally accepted accounting principles would be required. However, if such financial statements are not available, alternative presentations may be acceptable. For example, statutory financial statements of insurance companies serving as credit enhancers may be accepted.

The staff considers the following factors in assessing the sufficiency of the disclosure in this area: (i) amount of the credit enhancement in relation to the issuer's income; (ii) duration of the credit enhancement; (iii) conditions precedent to the application of the credit enhancement; and (iv) other

factors that indicate a material relationship between the credit enhancer and the purchaser's anticipated return.

D. Surviving Company in a Reverse Acquisition

APB No. 16, paragraph 70 states in part "...that presumptive evidence of the acquiring corporation in a combination effected by an exchange of stock is obtained by identifying the former common stockholder interests of a combining company which either retain or receive the larger portion of the voting rights in the combined corporation. That corporation should be treated as the acquirer unless other evidence clearly indicates that another corporation is the acquirer..."

SAB Topic 2A affirms the above principle and discusses some of the factors which may rebut the normal presumption.

In December, 1989 the Emerging Issues Committee of the Canadian Institute of Chartered Accountants reached a consensus concerning Reverse Takeover Accounting which is compatible with the guidance included in Topic 2A. The EIC consensus indicates that the post reverse-acquisition comparative historical financial statements should be those of the "legal" acquiree, with appropriate footnote disclosure concerning the change in the capital structure.

The merger of a private operating company into a non-operating public shell corporation is considered by the staff to be essentially a capital transaction, rather than a business combination. That is, it is equivalent to the issuance of stock by the private company for the net monetary assets of the shell corporation, accompanied by a recapitalization. The accounting is identical to that resulting from a reverse acquisition, except that no goodwill or other intangible should be recorded.

E. Redeemable Equity Securities

The staff considers the guidance in SX 5-02, FRC 211, SAB 3C, and SAB 6B(1) to be applicable to all equity securities (not only preferred stock) the cash redemption of which is outside the control of the issuer. For example, the guidance is applicable to common stock and common stock options and warrants that are subject to a put, and to stock subject to rescission rights.

Redeemable equity securities should be presented separately from "stockholders' equity" if they are redeemable at the option of the holder, or at a fixed date at a fixed price, or redemption is otherwise beyond the control of registrant. The presentation is required even if the likelihood of the redemption event is considered remote. Disclosures include title of security, carrying amount, and redemption amount on face of balance sheet; in notes, disclose general terms, redemption requirements in each of the succeeding five years, number of shares authorized, issued and outstanding.

Redeemable securities are initially recorded at their fair value. In subsequent periods, the security should be accreted to the redemption amount using the interest method (unless the likelihood of redemption is remote or the earliest date which redemption may legally occur is indeterminable). The amount of periodic accretion reduces income applicable to common shareholders in the calculation of EPS. [SAB 3C] If accretion is material, separate disclosure of income applicable to common shareholders on the face of the income statement is required. [SAB 6B(1)] If the redemption amount is currently redeemable and variable (eg., based on market value of common stock), the security should be adjusted to its full redemption value at each balance sheet date. The staff believes that an extinguishment of redeemable securities for consideration that exceeds the carrying amount of the securities at that time should be treated as a reduction of income applicable to common shareholders. However, the staff has not objected in a situation where an early extinguishment "sweetener" (amount in excess of the instrument's originally contracted redemption amount) was not considered in the EPS calculation.

F. Distributions to Promoters/Owners at or prior to Closing of IPO [SAB Topic 1.B.3]

If a planned distribution to owners (whether declared or not, whether to be paid from proceeds or not) is not reflected in the latest balance sheet but would be significant relative to reported equity, a pro forma balance reflecting the distribution (but not giving effect to the offering proceeds) should be presented along side the historical balance sheet in the filing.

If a distribution to owners (whether already reflected in the balance sheet or not, whether declared or not) is to be paid out of proceeds of the offering rather than from the current year's earnings, historical per

share data should be deleted and pro forma per share data should be presented (for the latest year and interim period only) giving effect to the number of shares whose proceeds would be necessary to pay the dividend. For purposes of this SAB, a dividend declared in the latest year would be deemed to be in contemplation of the offering with the intention of repayment out of offering proceeds to the extent that the dividend exceeded earnings during the previous twelve months.

G. Other Changes in Capitalization at or prior to Closing of IPO

Generally, the historical balance sheet or statement of operations should not be revised to reflect conversions or term modifications of outstanding securities that become effective after the latest balance sheet date presented in the filing, although pro forma data presented along side of the historical statements (as discussed below) may be necessary. However, if the registrant and its independent accountants elect to present a modification or conversion as if it had occurred at the date of the latest balance sheet (with no adjustment to earlier periods), the staff ordinarily will not object unless the original instrument legally accrues interest or dividends or accretes toward redemption value after that balance sheet date, or if the terms of the conversion do not confirm the historical carrying value at the latest balance sheet as current value.

If the terms of outstanding equity securities will change subsequent to the date of the latest balance sheet and the new terms result in a material reduction of permanent equity, or if redemption of a material amount of equity securities will occur in conjunction with the offering, the filing should include a pro forma balance sheet (excluding effects of offering proceeds) presented along side of the historical balance sheet giving effect to the change in capitalization.

If a conversion of outstanding securities will occur subsequent to the latest balance sheet date and the conversion will result in a material reduction of earnings applicable to common shareholders (excluding effects of offering), the staff will not object to the deletion (or inclusion solely in the notes to financial statements) of historical earnings per share if such information is not meaningful. Pro forma EPS for the

latest year and interim period should be presented giving effect to the conversion (but not the offering).

H. Calculation of EPS in an Initial Public Offering [SAB Topic 4D]

In the Initial Offering Document: <u>All</u> stock, options and warrants issued within one year prior to filing of the registration of an entity's initial public offering of its equity securities are deemed outstanding for all periods presented (in the manner of a stock split), except that the registrant may assume that the difference between the IPO offering price and the amount received for the stock or the exercise price of the options is applied to repurchase outstanding shares in the manner of the "treasury stock method" outlined in APB 15. (However, the "modified treasury stock method" described in APB 15 should not be applied, regardless of the proportion of equity represented by cheap stock, options, and warrants.) In periods prior to the offering, these securities should be deemed outstanding even if anti-dilutive (ie., when the registrant reports a loss).

In filings subsequent to the IPO: Stock, options and warrants deemed outstanding in the IPO pursuant to the SAB should continue to be deemed outstanding in all periods prior to the year in which the IPO is declared effective. In calculations of EPS for the fiscal year in which the IPO became effective, shares, options and warrants issued within one year prior to the IPO effective date should continue to be deemed outstanding as prescribed by the SAB throughout the interim period includes in the IPO prospectus. The determination of common stock and equivalents outstanding in remainder of the fiscal year (and in all subsequent reporting periods) should be determined on a basis consistent with APB 15. That is, outstanding options and warrants should be included in the EPS computation only if they have a dilutive effect; the application of the treasury stock method should not assume the IPO price to be the market price.

For example: Assume an option granted on January 1, with the IPO containing March 31 interims; an exercise price of $1; a IPO price of $2; and a weighted average market price at year-end of $3. Using the treasury stock method, the option represents one-half outstanding share in the first quarter and two-thirds share in the last three quarters; or five-eighths share for the full year.

I. Accounting for Shares Placed in Escrow in connection with an Initial Public Offering

In order to facilitate an initial public offering by some companies, underwriters have requested certain promoter/shareholder groups (or all shareholders of a closely held company) to place their shares in escrow, with subsequent release of the shares contingent upon the registrant's attainment of certain performance-based goals. Although these shares are legally outstanding and are reported as such on the face of the balance sheet, the staff considers the escrowed shares to be "contingent shares" for purposes of calculating earnings per share under APB 15. In addition, the staff views the placement of shares in escrow as a recapitalization by promoters similar to a reverse stock split. The agreement to release the shares upon the achievement of certain criteria is presumed by the staff to be a separate compensatory arrangement between the registrant and the promoters. Accordingly, the fair value of the shares at the time they are released from escrow should be recognized as a charge to income in that period. However, no compensation expense need be recognized with respect to shares released to a person that has had no relationship to the registrant other than as a shareholder (for example, is not an officer, director, employee, consultant or contractor), and that is not expected to have any other relationship to the company in the future.