CURRENT ACCOUNTING ISSUES AND RELATED DEVELOPMENTS AFFECTING THE DIVISION OF CORPORATION FINANCE
(as of July 1, 1993)

Teresa E. Iannaconi
U.S. Securities & Exchange Commission *
Washington, D.C.

----

* As a matter of policy, the Commission disclaims responsibility for any private publications by any of its employees. The views expressed are those of the author, and do not necessarily represent the views of the Commission or the author's colleagues on the staff.

CURRENT ACCOUNTING ISSUES AND RELATED DEVELOPMENTS AFFECTING THE DIVISION OF CORPORATION FINANCE
(as of July 1, 1993)

CURRENT ACCOUNTING ISSUES AND RELATED DEVELOPMENTS AFFECTING THE DIVISION OF CORPORATION FINANCE
(as of July 1, 1993)

I. Recently Adopted Rules and Interpretive Releases

A. Small Business Initiatives

On July 30, 1992, and April 27, 1993, 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 Old Form S-18 has been rescinded.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.

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. After the initial registration statement on Form S-B, 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. 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.

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. Additional Initiatives Relating to SB Disclosure System

On April 27, 1993, the Commission adopted additional rules and forms 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 the transitional filer rules, 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 and two years of audited financial statements for a public offering of up to $10 million in any continuous 12 month period. These small business issuers would be permitted to meet their subsequent Exchange Act reporting requirements using the Regulation A model of disclosure until such time as they either (1) register more than $10 million in any continuous 12 month period, (2) elect to graduate to another 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 were adopted, in addition to amendments to Schedule 14A under the proxy rules. Further a new Securities Act registration statement, Form SB-1, was adopted to permit qualifying small business issuers to make small registered offerings up to $10 million annually using the Regulation A format with two years of audited financial statements.

Two refinements to the financial statement requirements for small business issuers were also adopted. The first provides 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. 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 second refinement widens 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 1992 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

As amended in April 1993, Rule 504 permits a public offering of up to $1 million in a 12-month period by a non-Exchange Act reporting company subject only to the anti-fraud and other civil liability provisions of the federal securities laws. The amendment eliminated the conditions regarding state registration previously imposed by the Rule. In addition, Rule 504, as amended, permits general solicitation and general advertisement in connection with all offers and sales under the exemption. Rule 504 is not available to "blank check" companies.

B. Executive Compensation Disclosure

On October 15, 1992, the Commission adopted (Securities Act Release No. 6962) amendments to the executive compensation disclosure requirements of Item 402 of Regulation S-K. The amendments are designed to make compensation disclosure clearer and more concise, and of greater utility to shareholders.

The new rules require disclosure of all compensation to the named executive officers and directors of the registrant for services rendered to the registrant in all capacities. The named executive officers consist of the chief executive officer ("CEO") and the other four most highly compensated officers (collectively, the "named executive officers"). Except for the CEO, disclosure is limited to those executives with salary and bonus of over $100,000 (an increase from the former $60,000 threshold) for the last completed fiscal year.

The Summary Compensation Table is the linchpin of the Commission's revised executive compensation disclosure scheme. It is intended to provide shareholders with a comprehensive overview of the registrant's executive pay practices, identify trends in the registrant's compensation of its top managers and allow shareholders to compare such trends with those disclosed by other registrants. The Summary Compensation Table covers compensation of the named executive officers in each of the registrant's last three fiscal years, although two of the columns ("Other Annual Compensation" and the catch-all "All Other Compensation") may be phased in by companies over the first three years of reporting. In addition, small business issuers may phase in the entire table over 3 years. The Summary Compensation Table is required to be presented in the tabular format specified in Item 402 of Regulation S-K. Specifically the table contains three specific columns relating to annual compensation (Salary, Bonus, and Other), three specific columns relating to long-term compensation (Restricted Stock Awards, SARS & Options, and Long Term Incentive Payouts), and a final column reporting any compensation not reported under the any other column.

In addition to the information provided in the Summary Compensation Table, the new rules require several additional tables containing more specific data on the components of compensation disclosed in the Summary Compensation Table. The five additional tables require the registrant provide detailed information concerning:

* Grants of options and SARs to each of the named executives during the last fiscal year.
* Exercises by the named executives of options and SARs during the last fiscal year and the value of each of the named executives' outstanding options and SARs at year end.
* Awards under long-term incentive plans during the last fiscal year. Included in this table is compensation that is based on the registrant's performance for a period of more than one year.
* Compensation and disclosures related to pension and other defined benefit or actuarial plans.
* Disclosures relating to the repricing of options or SARs during the last fiscal year.

Further, in order to allow shareholders to compare compensation trends with those disclosed by other registrants, the new rules require a Performance Graph requiring registrants to provide a line graph comparing the registrant's cumulative total shareholder return (stock price appreciation plus dividends, on a reinvested basis) with a overall stock market return performance indicator (such as the S&P 500 stock index) and either a published industry index or registrant-determined peer comparison. Registrants not included in the S&P 500 may choose another broad equity market index for comparison. Registrants have broad discretion in determining their peer comparison. If they do not believe a peer comparison is feasible, they may disclose this belief and compare their shareholder return to one or more companies selected on the basis of similar market capitalization.

In addition, the new rules require a Board Compensation Committee Report on executive compensation which discloses, among other items, the registrant's compensation policies, including the specific relationship of corporate performance to executive compensation (Item 402(k)).

The information required by the option/SAR repricing table, the Board Compensation Committee Report, and the performance graph need not be provided in any filings other than the registrant's proxy or information statement relating to an annual meeting of security holders at which directors are to be elected (or special meeting or written consents in lieu of such meeting). Such information will not be deemed incorporated by reference into any filing under the Securities Act or Exchange Act, except to the extent that the registrant specifically incorporates it by reference.

Small business issuers eligible to use the small business integrated disclosure system will be required to provide only the summary compensation table, the option and SAR grant and exercise tables (omitting option valuation information), the long-term incentive plan awards table, and disclosure concerning option or SAR repricing (omitting the 10-year repricing history), named executive officer employment contracts and termination/severance arrangements, and director compensation (see Item 402 to Regulation S-B, as amended). Small businesses not electing to use the small business integrated disclosure system may nonetheless provide this more streamlined disclosure pursuant to Item 402(a)(1)(i) of Regulation S-K. In addition, small business issuers are eligible to file under the rules in effect prior to the effective date until May 1, 1993.

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

On February 23, 1993, the Commission issued four releases adopting the rules that had been proposed in July 1992 requiring 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 also contain phase-in schedules to bring registrants (as well as parties making filings with respect to these registrants) onto the EDGAR system. That phase-in began on April 26, 1993. The new rules became effective April 26, except the provisions relating to Financial Data Schedules are effective November 1, 1993. The rules were published in the Federal Register on March 18, 1993. The EDGAR Filer Manual was published in the Federal Register on April 9, 1993.

The first release (Securities Act Release No. 6977) explains the EDGAR system generally and sets forth rules and procedures that apply to electronic submissions by the Division of Corporation Finance and in some cases, to those processed by the Division of Investment Management. The second release (Investment Company Act Release No. 19284) adopts rules specific to electronic submissions made by investment companies. The third release (Public Utility Holding Company Act Release No. 25746) adopts rules specific to electronic submissions made by public utility holding companies and their subsidiaries. The fourth release (Securities Act Release No. 6980) relates to the payment of filings fees, by both paper and electronic filers, to the Commission's lockbox depository at Mellon Bank in Pittsburgh, Pennsylvania pursuant to Rule 3a of the Rules Relating to Informal and Other Procedures.

The EDGAR pilot has been operational since September 24, 1984. Through the closing of the EDGAR Pilot on July 14, 1992, the Commission received over 116,000 electronic filings from over 1800 filers. The new EDGAR system began receiving live filings by the former EDGAR participants ("Transitional Filers") on July 15, 1992. On April 26, 1993, the temporary rules were superseded by the new rules adopted in February 1993. The new rules, including the most recent version of the EDGAR Filer Manual, will govern the preparation and transmission of electronic submissions. 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. Accordingly, the rules adopted in February 1993 are referred to as "interim rules."

The "significant test group" will be phased in between April and December 1993, in four groups. The first group began phase-in on April 26, 1993. Group CF-01 consists of approximately 230 companies - mostly Transitional Filers, with a few additional volunteers. The next group, Group CF-02, consisting of approximately 700 registrants whose filings are processed by the Division of Corporation Finance, will begin mandated electronic filing on July 19, 1993. The third group (Group CF-03) and fourth group (Group CF-04) of the significant test group will consist of approximately 700 and 900 registrants, respectively, whose filings are processed by the Division.

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. Registrants will then be phased in, in groups of approximately 500, 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. This residual category does not include foreign private issuers or foreign governments, which will not be required to file on EDGAR at this time, although they will be considered if they wish to volunteer.

D. Environmental and Product Liability Loss Contingencies

On June 8, 1993, the staff issued Staff Accounting Bulletin No. 92 ("SAB 92") which expresses certain views of the staff regarding accounting and disclosures relating to loss contingencies. This SAB pertains to all loss contingencies, but provides additional guidance for environmental and product liabilities.

The SAB states that offsetting a claim for recovery that is probable of realization against a probable contingent liability in the balance sheet ordinarily is not appropriate. This view is consistent with the consensus reached by the Emerging Issues Task Force (EITF) on Issue No. 93-5 that indicated that an environmental liability should be evaluated separately from any potential claim for recovery. Any loss arising form the recognition of an environmental liability should be reduced by a potential claim only when that claim is probable of realization. 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 probable recovery should be presented separately on the face of the balance sheet. The staff will not object to net presentation until the adoption of FIN 39 (to be applied to fiscal years beginning after December 15, 1993) provided that the notes to the financial statements disclose the gross amount of each component of the net liability. The staff believes there is a rebuttable presumption that no asset should be recognized for a claim for recovery from a party that is asserting that it is not liable to indemnify the registrant. Registrants that overcome that presumption should disclose the amount of recorded recoveries that are being contested and discuss the reasons for concluding that the amounts are probable of recovery.

The EITF also reached a consensus to Issue 93-5 stating that discounting of environmental liabilities is appropriate only when the aggregate obligation and the amount and timing of the payments are fixed or reliably determinable. That consensus sets forth criteria for discounting and disclosure requirements where discounting is appropriate. The EITF could not reach a consensus on the appropriate discount rate. The staff believes that the rate applicable is that rate where the liability could be settled in an arm's length transaction. If that rate is not readily determinable, the SAB states that the rate should not exceed the interest rate on risk free monetary assets having maturities comparable to that of the liability.

Registrants should avoid boiler plate disclosures regarding the possible impact of significant uncertainties. For example, a statement that the contingency is not expected to have a material effect on financial condition could be incomplete or confusing if the possible loss would be material to an investor based on another reasonable measure, such as one relating to liquidity or operating results. Further, this representation implies that management has determined the range of possible loss. If it is reasonably possible that the outcome of uncertainties may result in a liability exceeding the accrued liability by an amount which would be material, paragraph 10 of SFAS 5 requires disclosure of that range of reasonably possible loss or a clear statement that a range cannot be estimated.

Registrants are reminded that, notwithstanding significant uncertainties affecting the measurement of contingencies, 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.

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 its own and other companies' prior experience in cleaning up contaminated sites 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.

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, including disclosure of the aggregate expected cost to remediate sites where the likelihood of contribution by other significant parties has not been established; the nature and terms of cost-sharing arrangements with other PRPs; the extent to which disclosed but unrecorded contingent losses are subject to recovery through insurance, indemnification arrangements, or other third parties, with disclosure of the limitations of that recovery; 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 SFAS 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.

The SAB advises registrants operating in a rate regulated environment that the recordation of a liability for a loss contingency does not automatically give rise to a regulatory asset. Registrants are directed to the criteria for asset recognition in paragraph 9 of SFAS 71. The SAB indicates that recognition of a contingent loss should not be delayed until the registrant is advised by the regulator as to whether such costs are allowable for rate making purposes.

E. Amendments to Multijurisdictional Disclosure System

On July 1, 1993, the Commission adopted amendments to the MJDS (Securities Act Release No. 7004) to provide for retention of the requirement that financial statements included in filings on Forms F-10 and 40-F include a reconciliation to U.S. GAAP. In connection with the adoption of the MJDS in 1991 the Commission had provided that the reconciliation requirement would cease for certain MJDS filings after July 1, 1993 unless the Commission acted to retain the requirement. A staff report regarding reconciliation of financial statements of foreign issuers indicated that there continue to be significant differences in accounting principles and practices between Canadian and U.S. GAAP. The Commission concluded that the differences between Canadian and U.S. GAAP materially affect reported financial position and results of operations and related trend information which warrant retention of the currently existing reconciliation requirements.

II. Other Accounting and Disclosure Issues of Current Interest

A. 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 deductible 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.

B. Issues Affecting Insurance Companies

1. Retrospectively Rated Contracts

At the March 16, 1993, meeting of the Emerging Issues Task Force, the FASB staff and SEC Observer expressed their views regarding the accounting for certain reinsurance arrangements, commonly called "funded catastrophe covers". Through a variety of contractual adjustment features, these arrangements may effectively require a ceding insurer to repay loss reimbursements previously received from a reinsurer. The SEC staff is of the view that funded catastrophe covers which do not transfer insurance risk under SFAS 60 must be accounted for as a deposit arrangement, rather than as reinsurance. Even when a funded catastrophe cover transfers significant insurance risk to a reinsurer, loss recognition under SFAS 5 is required when the ceding insurer has an obligation for future payments that will not result in a commensurate future benefit. Registrants that have accounted for funded catastrophe covers on a basis other than as described above during 1991 or 1992 will be required to restate their financial statements accordingly.

2. Assumption Reinsurance

Insurance companies should consider the accounting and disclosures implications of a recent federal district court decision (<u>Security Benefit Life Insurance Company v. FDIC</u>). That decision held that state laws require the consent of the insured before the ceding company's liabilities may be extinguished in an assumption reinsurance transaction. Consequently, an insurance company may be held primarily or contingently liable for policy liabilities transferred in assumption reinsurance transactions where consent of policyholders has not been obtained. Registrants should consider the requirements of SFAS 5 (with respect to recognition or disclosure of this contingency in the financial statements), and Item 303 of Regulation S-K (with respect to disclosure in MD&A of the reasonably likely effects of this uncertainty).

SFAS 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts, effective for 1993 year-end financial statements, prohibits the removal of policy liabilities from the financial statements when the reinsurance contract does not relieve the ceding insurer of the legal liability to the policyholder. Registrants should consider the applicability of the federal district court decision in assessing whether legal liability has been extinguished.

C. 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.

D. 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.

E. Disclosures and Accounting for Discontinued Operations

In the course of its reviews of filings by registrants during the last few years, the staff has encountered a number of issues relating to the accounting and disclosures for discontinued operations. The staff's views regarding a number of these matters follows:

1. Significant interest retained: A registrant that disposes of its controlling interest in an operation that is a business segment as defined by APB 30 should not classify the historical operating results of the segment and gain or loss on its disposal outside of continuing operations if the registrant retains a sufficiently large minority voting interest directly in the segment or in the buyer of the segment such that the registrant is required by APB 18 to account for its residual investment using the equity method. The staff believes retention of an interest sufficient to enable the registrant to exert significant influence over the segment's operating and financial policies is indicative of a level of continuing involvement with the segment that is inconsistent with its classification as a discontinued business. In these circumstances, the transaction should be accounted for

as the disposal of a portion of a line of a business with its effects classified within continuing operations pursuant to the AICPA interpretation to APB 30.

2. Subsequent developments: A registrant that received debt or equity securities of the buyer of a discontinued segment as consideration in the sale should not record subsequent changes in the carrying value of those securities within discontinued operations. The staff believes changes in the net carrying value of assets received in consideration on the sale of a segment do not affect the determination of gain or loss at the disposal date, but represent the consequences of management's hold-or-sell decisions with respect to those assets after the disposal date. Gains and losses, dividend and interest income, and portfolio management expenses associated with assets received as consideration for discontinued operations should be reported within continuing operations, classified in a manner consistent with the income and expenses associated with other, similar investments of the registrant. However, adjustments of estimates of contingent liabilities or contingent assets which remain after disposal of a segment or which arose pursuant to the terms of the disposal generally should be classified within discontinued operations.

3. Disclosures: MD&A should include disclosure of known trends, events and uncertainties involving discontinued operations that may materially affect the registrant's liquidity, financial condition, and results of operations (including net income) between the measurement date and the date when the material risks of those operations will be transferred or otherwise terminated. Contingent liabilities, such as product or environmental liabilities, that may remain with the registrant notwithstanding disposal of the underlying business should be disclosed in the financial statements pursuant to SFAS 5 and discussed in MD&A pursuant to Item 303 of Regulation S-K.

4. Qualifying Plan of Disposal: The staff believes that a plan of disposal of operations does not qualify the disposition for classification outside continuing operations unless it contemplates the likely consummation of the sale, abandonment, or other disposition of all portions of the business segment within twelve months of the plan's adoption. However, if a registrant's plan contemplates the cessation within twelve months of all <u>new</u> revenue producing activity (other than renewal of existing contracts

where the registrant is obligated to honor renewal demands), the staff will not object to classification of the business as a discontinued operation, notwithstanding the fact that the registrant may continue for several years to receive payments from customers under existing contracts and incur significant operating costs to fulfill its obligations under the contracts, if the results of operations through final termination of the business can be reasonably estimated. However, in periods in which the residual operations are material, the staff would expect summarized disclosure of the abandoned segment's operating results and of material charges or credits recognized to adjust any provision for loss that was accrued at the measurement date.

5. Deconsolidation: Deconsolidation may not be used ordinarily with respect to subsidiaries which management intends to sell but for which no qualifying plan of disposal has been adopted. The staff believes that, until a plan of disposal satisfying the criteria of APB 30 is adopted by management, subsidiaries should continue to be consolidated in the Company's financial statements unless events outside the effective influence of the registrant are indicative that control does not rest with the registrant or is likely to be lost.

F. 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, the method by which the standard will be adopted, the impact that the standard will have on the financial statements to the extent reasonably estimable, and 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 APB 28, as amended by SFAS 3. In addition, the staff believes the interim financial statements should include, to the extent applicable, all disclosures 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 pursuant to SFAS 3. If the new accounting principle is applied retroactively to prior years, the prior comparable interim quarters should be presented on a restated basis also. Disclosures specific to SFAS 106 and SFAS 109 which the staff would expect to see in the interim financial statements of the period in which one of those standards was adopted include the following:

(a) SFAS 109 (Income Taxes): Registrants that adopt SFAS 109 in an interim quarter of their fiscal year should disclose in the Form 10-Q the items described in paragraph 43 (total deferred assets, liabilities and valuation allowance; approximate tax effect of each type of temporary difference and carryforward). This disclosure may be based on the calculation as of the first day of the fiscal year (rather than the last day of the quarter). The allocation of taxes between continuing operations and other items (paragraph 46) should be disclosed. If disclosures that would be made pursuant to paragraphs 44 (deferred tax exceptions), 45 (significant components of expense), 47 (statutory to actual rate reconciliation) and 48 (carryforwards and carrybacks) would vary materially from those depicted in the prior Annual Report, these variances should be discussed and quantified. Reasons for significant variations in the customary relationship between income tax expense and pretax accounting, if not otherwise apparent, should be discussed.

(b) SFAS 106 (Other Postemployment Benefits): Registrants that adopt SFAS 106 in the first quarter of their fiscal year should include all of the disclosures required by paragraph 74 of SFAS 106. These disclosures include a general description of the substantive plan; the registrant's funding policy; the types of assets held by the plan and significant nonbenefit liabilities of the plan; a schedule reconciling the funded status of the plan with amounts reported in the registrant's statement of financial position; the rates assumed by the registrant with respect to health care cost trends, discount factors, compensation increases, and the expected long-term return on plan assets; the effect of a one-percentage-point increase in the assumed health care cost trend rate; the amounts and types of any securities of the employer which are included as plan assets; and whether modifications of the existing plan are contemplated by the substantive plan. This disclosure may be based on the calculation as of the first day of the fiscal year (rather than the last day of the quarter). The registrant should also disclose the amount of the estimated net periodic postretirement benefit cost and its components for the interim period.

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

During 1991 and 1992, the Commission instituted proceedings and issued cease and desist orders against four financial institutions for violations of Sections 13(a), 13(b)(2)(A) and (B) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-13 thereunder in connection with financial statements and disclosures concerning investment securities which had experienced other than temporary declines in market value. (See Fleet/Norstar Financial Group, Release No. 34-29557; Excel Bancorp, Inc., Release No. 34-29675; Abington Bankcorp, Inc., Release No. 34-30614; Presidential Life Corporation, Release No. 34-31934). In each of these situations, the registrant reported an investment securities portfolio at a carrying value that substantially exceeded the market value of the securities. In each case, the registrant accounted for certain market declines as temporary.

Generally accepted accounting principles provide that temporary declines in the value of non-current investment securities generally may be recognized through adjustments to a valuation allowance account within stockholders' equity. However, Statement of Financial Accounting Standard No. 12, Accounting for Certain Marketable Securities (SFAS 12), requires that a determination be made as to whether a decline in market value below cost as of the balance sheet date of an individual security is "other than temporary". If the decline is judged to be other than temporary, the cost basis of the individual security must be written down to a new cost basis and the amount of the write down must be accounted for as a realized loss. The new cost basis is not changed for subsequent recoveries in market value.

In each of these cases the registrant held a portfolio of equity and/or debt securities which had substantial and continuing unrealized losses. Staff Accounting Bulletin No. 59 (SAB 59) sets forth the staff's views concerning the evaluation of some of the factors which, individually or in combination, indicate that a decline in market value below an investor's carrying value is other than temporary and that a write down of the carrying value is required. These factors are: (a) the length of time and the extent to which the market value has been less than cost; (b) the financial condition and near term prospects of the issuer, including any specific events which may influence the operations of the issuer such as changes in its technology that may impair earnings potential of the investment or the discontinuance of a segment of the business that may affect the future earnings potential; and (c) the intent and ability of the holder to retain its investment in the issuer for a period sufficient to allow for any anticipated recovery in market value.

Pursuant to SAB 59, "unless evidence exists to support a realizable value equal to or greater than the carrying value of the investment, a write down accounted for as a realized loss should be recorded." The Commission stated in the Fleet/Norstar order that "Recoveries that cannot be reasonably expected to occur within an appropriate period should not be considered in the assessment of realizable value."

In each of these cases the Commission concluded that the registrant had failed to timely recognize losses on other than temporary declines in investments.

III. 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 staff interpretation in unusual situations or obtain 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. 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.

C. 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.

D. 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.

E. 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.

F. 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).

G. 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.

H. 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.

I. 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 <u>current</u> 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.

J. 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.