CHAPTER 2
CASH

INTRODUCTION

Rule 5-02-1 of Regulation S-X requires separate disclosure for cash and cash items legally restricted as to usage or withdrawal. This disclosure generally is made on the face of the balance sheet. The terms of the restrictions must be described in a note to the financial statements. Time deposits generally are not deemed to be restricted, and compensating balance arrangements that do not legally restrict the amounts shown in the balance sheet need only be disclosed. Compensating balances that are maintained under an agreement to ensure future credit availability should be disclosed in the notes, along with the terms of the agreement. SEC interpretations and guidelines with respect to compensating balances can be found at FRR Section 203 and SAB Topic 6H.

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Question	Yes	No	Disclosure Requirement Met?	Reference
1. Does the company have restrictions on its cash?	____	____	____	____

Disclosure Requirements

Restricted Foreign Currency

Cash in one country may not be freely transferable to another country because of exchange control regulations or other reasons. If the restricted funds held in another country are significant, they should be segregated or disclosed in a caption or note. If the restricted funds cannot be (or are not intended to be) used for general business purposes in the country where they are located, such funds should be classified as noncurrent assets in a classified balance sheet.

Other Restricted Funds

Significant amounts of funds that are legally restricted in other ways also should be segregated or disclosed in a caption or note. Funds held in escrow, proceeds from loans restricted for specified purposes, and reserve funds required under bond indentures are examples of such funds. If such funds are to be used to acquire noncurrent assets or to liquidate long-term liabilities, they should be classified as long term in a classified balance sheet. However, if funds are restricted for the payment of interest, current maturities of debt or other current liabilities, they should be classified as current.

Disclose the amount of cash and cash items restricted as to withdrawal or usage separately presented on the balance sheet (time deposits generally are not deemed restricted), the provisions of such restrictions, compensating balance amounts, and arrangements.

References: Regulation S-X, Rule 5-02-1 (Rule 5-02 is reflected in the FASB Accounting Standards Codification™ (ASC) at ASC 210, Balance Sheet (ASC 210-10-S99-1)); FRR 203; SAB Topic 6H (SAB Topic 6H is reflected in the ASC at ASC 210-10-S99-2)

Regulation S-X, Rule 5-02-1; FRR 203; SAB Topic 6H

Rule 5-02: Balance Sheets

1. CASH AND CASH ITEMS.

Separate disclosure shall be made of the cash and cash items which are restricted as to withdrawal or usage. The provisions of any restrictions shall be described in a note to the financial statements. Restrictions may include legally restricted deposits held as compensating balances against short-term borrowing arrangements, contracts entered into with others, or company statements of intention with regard to particular deposits; however, time deposits and short-term certificates of deposit are not generally included in legally restricted deposits. In cases where compensating balance arrangements exist but are not agreements which legally restrict the use of cash amounts shown on the balance sheet, describe in the notes to the financial statements these arrangements and the amount involved, if determinable, for the most recent audited balance sheet required and for any subsequent unaudited balance sheet required in the notes to the financial statements. Compensating balances that are maintained under an agreement to assure future credit availability shall be disclosed in the notes to the financial statements along with the amount and terms of such agreement.

FRR 203. Disclosure of Compensating Balances and Short-Term Borrowing Arrangements

ASR 148

203.01. Reasons for Requirements

The management of liquidity is an important part of the financial management of a business entity. The maintenance of short-term borrowing capacity and the ability to obtain such funds at reasonable cost are major elements of such a management responsibility. If investors are to understand the financial policies of management, disclosure relative to these elements is necessary.

It is generally recognized in the financial community that one of the major elements in short-term financing policy is the maintenance of compensating balances supporting present and future credit from financial institutions. Such balances affect liquidity and the effective cost of borrowing. Nevertheless, disclosure of the essential details of such arrangements had been infrequent. When disclosure had occurred, the information supplied was generally insufficient to permit statement users to deal analytically with the subject. Lack of disclosure of amounts affecting liquidity such as compensating balances has been justified on the grounds that such arrangements were generally unwritten, informal and not subject to precise quantification. None of these reasons are sufficient to support a policy of nondisclosure of situations which are recognized to be both real and significant. They do, however, support the need for rule changes and disclosure guidelines so that reasonably uniform and understood standards for disclosure can be applied. They also indicate that disclosure must be based in many circumstances on reasonable estimates and that precision of measurement cannot be expected.

The interest paid for short-term borrowings is also of significance in appraising the financial policies and operating results of business entities. Changes in this rate over time may have a significant impact on profitability. The relationship of the rate paid at year end to short-term rates generally being charged at that date to corporate borrowers may be indicative of the future level of interest costs to be incurred by the corporation under varying conditions in the credit markets. In addition, information as to the magnitude of such borrowings during a fiscal period should further assist investors in determining the impact of changing credit conditions on business operations.

203.02 Compensating Balances

Rule 5-02-1 of Regulation S-X requires disclosure of compensating balances in order to avoid undisclosed commingling of such balances with other funds having different liquidity characteristics and bearing no determinable relationship to borrowing arrangements. Rule 5-02-1 also requires footnote disclosure distinguishing the amounts of such balances maintained under a formal agreement to assure future credit availability.

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203.02.a. Definition

A compensating balance is defined as that portion of any demand deposit (or any time deposit or certificate of deposit) maintained by a corporation (or by any other person on behalf of the corporation) which constitutes support for existing borrowing arrangements of the corporation (or any other person) with a lending institution. Such arrangements would include both outstanding borrowings and the assurance of future credit availability.

203.02.b. Form of Disclosure

The manner of disclosure cannot be specified with precision since it will vary according to the factual situation involved. These rules call for disclosure of compensating balance arrangements. Such disclosure will involve segregation on the face of the balance sheet whenever such balances are maintained under an agreement which legally restricts the use of such funds. Examples of such arrangements would include situations where a certificate of deposit must be held while a loan is outstanding or where a minimum balance must be maintained at all times while credit is extended or available. Footnote disclosure will be appropriate in other circumstances where such balances are determinable amounts although not legally restricted as to withdrawal. Footnote disclosure would be required even though the arrangement is not reduced to writing if determinable amounts (e.g., a percentage of short-term borrowings, a percentage of unused lines of credit, an agreed average balance) have been agreed upon by both parties involved. An arrangement where the balance required is expressed as an average over time would ordinarily lead to additional footnote disclosure of the average amount required to be maintained for arrangements in existence at the reporting date since the amount held at the close of the reporting period might vary significantly from the average balance held during the period and bear little relationship to the amount required to be maintained over time. If arrangements requiring maintenance of compensating balances during the year were materially greater than those at year end, that fact should be disclosed. Disclosure may also include a statement, if appropriate, that the amounts are legally subject to withdrawal with or without sanctions, as applicable. If many banks are involved, the disclosure should summarize the most common arrangements and aggregate the compensation balances involved.

Restrictions of the use of funds may include contracts entered into with others or company statements of intention with regard to particular deposits. Examples of the former might be letters of credit and escrow accounts. Examples of the latter are cash balances set aside for use in a capital expenditure program or to meet a particular debt obligation when it comes due. Cash balances related to statements of intention should only be segregated when particular deposits or balances have been earmarked for such special purposes. Board approval of a capital budget calling for the expenditure of certain amounts would not be the basis for segregation unless the specific amounts of cash to be spent are identified and set aside.

Where a company is not in compliance with a compensating balance requirement, that fact generally should be disclosed along with stated or possible sanctions whenever such possible sanctions may be immediate (not vague or unpredictable) and material. In determining whether compensating balance arrangements are sufficiently material to require segregation or disclosure, various factors should be considered. Among these may be the relationship of the amount of the balances, to total cash, total liquid assets and net working capital, and the impact of the balances on the effective cost of financing. In the usual case, reportable compensating balances which in the aggregate amount to more than 15 percent of liquid assets (current cash balances, restricted and unrestricted, plus marketable securities) would be considered to be material. Lesser amounts may be material if they have a significant impact on the cost of financing. Compensating balances maintained by the company for the benefit of affiliates, officers, directors, principal stockholders or other similar parties may be of particular significance to investors. Separate disclosure of such balances may be required under other Commission rules and regulations even if they are not of a magnitude such that they would meet the materiality guidelines set forth above.

203.02.c. Measurement Problems

A number of problems arise in the process of determining the amount of compensating balances. It is recognized that precision of measurement may not be practicable but that fact should not limit the disclosure of material arrangements since reasonable estimates can be made. Since several of the problems of measurement occur frequently, and since it is desirable that they be similarly solved to assure uniformity of practice among companies, the following guidelines have been developed to assist registrants. It is recognized that every situation cannot be anticipated, and the need for judgment on the part of registrants and their auditors cannot and should not be avoided.

203.02.c.i. Minimum Operating Balance

All corporations require some minimum amount of cash on which to operate. The amount will depend upon the extent of seasonal and random fluctuations in short-term cash demand as well as management judgment regarding necessary safety factors. It has been argued that in those cases where part of the compensating balance reflects funds that would be held any way as a minimum operating balance, such funds should be subtracted from compensating balance since the maintenance of such a compensating balance has no incremental cost to the borrower. For purposes of these disclosure requirements, such a subtraction is not appropriate. The concept of subtraction implies that the compensating balance is of secondary importance, and this is by no means apparent. It would be equally reasonable to contend that operating funds are free of cost because compensating balances must be maintained. In any event, the utilization of such amounts of compensating balances precludes the sound cash management alternative of investing available cash in highly liquid interest bearing securities. It may be desirable, however, for companies to supplement disclosure with statements regarding the dual purpose of such amounts.

203.02.c.ii. Float

The balance shown on the bank's ledgers and the company's books will differ due to delays in presentment of checks in transit. In addition, some amounts included in the bank ledger figure may include funds subject to collection which may not be considered as meeting compensating balance requirements. These factors complicate the calculation of the amount of compensating balance to be disclosed both conceptually and empirically. The compensating balance arrangements negotiated between a company and its bank are normally expressed in terms of the collected bank ledger balance, but the financial statements are presented on the basis of the company's books. In order to make the disclosure of compensating balance amounts segregated on the balance sheet consistent with the cash amounts reflected in the financial statements, the balance figure agreed upon by the bank and the company should be adjusted, if possible, by

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the estimated "float" so that such an adjusted amount shown on the balance sheet will properly relate to company book amounts for total cash. Both the agreed upon collected balance at the bank and the adjusted balance relating to the corporation's books should be disclosed along with a brief description of the criteria used to make the adjustment. Similar adjustments and disclosure should be made for arrangements disclosed in the footnotes if practicable and relevant to the arrangements described. A reasonable estimate of "float" based on the information management uses to manage its bank relationship will be satisfactory.

203.02.c.iii. Compensation for Other Bank Services

Balances are maintained not only in connection with financial arrangements but also to compensate the bank for its account handling function, and in some cases, to pay for other services such as lock boxes and account reconcilement. Balances maintained for these purposes should not be included in the disclosed compensating balances and would not be construed as special funds per Rule 5-02-1 since such funds are available for use upon payment of a service charge and would not affect the cost of borrowing. If a bank allows balances to serve both purposes, the balances should be considered as a compensating balance and should be disclosed in accordance with Rule 5-02-1. Supplement disclosure by companies for the dual purpose of such amounts may be desirable.

203.02.c.iv. Reporting Periods

In general, compensating balance arrangements should only be disclosed for the latest fiscal year and later interim period for which statements are presented. If the terms of the arrangements require balance sheet segregation, however, this should be reflected in all balance sheets presented. In addition, if the change in the arrangements from one period to the next is so great as to constitute a fact of unusual significance to the investor in appraising the company, the change should be disclosed.

203.03. Funds Maintained for Future Credit Availability

Rule 5-02-1 requires disclosure of funds maintained under an agreement for the purpose of assuring future credit availability. These funds would be included as part of compensating balances disclosed separately on the balance sheet or in the footnotes in accordance with Rule 5-02-1. This requirement contemplates separate disclosure of such amounts and the related terms for both long-and short-term future credit availability in notes to the financial statements. Separate disclosure provides important and useful information to the investor about policies regarding cash management and future financing.

SAB Topic 6: Interpretations of Accounting Series Releases and Financial Reporting Releases

H. ACCOUNTING SERIES RELEASE 148—DISCLOSURE OF COMPENSATING BALANCES AND SHORT-TERM BORROWING ARRANGEMENTS (ADOPTED NOVEMBER 13, 1973, AS MODIFIED BY ASR 172 ADOPTED ON JUNE 13, 1975, AND ASR 280 ADOPTED ON SEPTEMBER 2, 1980)

Facts: ASR 148 (as modified) amends Regulation S-X to include:

1. Disclosure of compensating balance arrangements.
2. Segregation of cash for compensating balance arrangements that are legal restrictions on the availability of cash.

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1. Applicability

a. Arrangements with other lending institutions

Question: In addition to banks, is ASR 148 applicable to arrangements with factors, commercial finance companies or other lending entities?

Interpretive Response: Yes.

b. Bank holding companies and brokerage firms

Question: Do the provisions of ASR 148 apply to bank holding companies and to brokerage firms filing under Rule 17a-5?

Interpretive Response: Yes; however, brokerage firms are not expected to meet these requirements when filing Form X-17a-5.

c. Financial statements of parent company and unconsolidated subsidiaries

Question: Are the provisions of ASR 148 applicable to parent company financial statements in addition to consolidated financial statements? To financial statements of unconsolidated subsidiaries?

Interpretive Response: ASR 148 data for consolidated financial statements only will generally be sufficient when a filing includes consolidated and parent company financial statements. Such data are required for each unconsolidated subsidiary or other entity when a filing is required to include complete financial statements of those entities. When the filing includes summarized financial data in a footnote about such entities, the disclosures under ASR 148 relating to the consolidated financial statements will be sufficient.

d. Foreign lenders

Question: Are ASR 148 disclosure requirements applicable to arrangements with foreign lenders?

Interpretive Response: Yes.

2. Classification of short-term obligations—Debt related to long-term projects

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

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

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

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

3. Compensating balances

a. Compensating balances for future credit availability

Facts: Rule 5-02-1 of Regulation S-X requires disclosure of compensating balances in order to avoid undisclosed commingling of such balances with other funds having different liquidity characteristics and bearing no determinable relationship to borrowing arrangements. It also requires footnote disclosure distinguishing the amounts of such balances maintained under a formal agreement to assure future credit availability.

Question: In disclosing compensating balances maintained to assure future credit availability, is it necessary to segregate compensating balances for an unused portion of a regular line of credit when a total compensating balance amount covering both used and unused amounts of a line of credit is disclosed?

Interpretive Response: No.

b. Changes in compensating balances

Facts: ASR 148 guidelines indicate the need for additional disclosures where compensating balances were materially greater during the period than at the end of the period.

Question: Does this disclosure relate to changes in the arrangement (e.g., the required compensating balance percentage) or changes in borrowing levels?

Interpretive Response: Both.

c. Float

Facts: ASR 148 states that "compensating balance arrangements . . . are normally expressed in terms of collected bank ledger balances but the financial statements are presented on the basis of the company's books. In order to make the disclosure of compensating balance amounts . . . consistent with the cash amounts reflected in the financial statements, the balance figure agreed upon by the bank and the company should be adjusted if possible by the estimated float."

Question: In determining the amount of "float" as suggested by ASR 148 guidelines, frequently an adjustment to the bank balance is required for "uncollected funds." On what basis should this adjustment be estimated?

Interpretive Response: The adjustment should be estimated based upon the method used by the bank or a reasonable approximation of that method. The following is a sample computation of the amount of compensating balances to be disclosed where uncollected funds are involved.

Assumptions: The company has agreed to maintain compensating balances equal to 20 percent of short-term borrowings.

Short-term borrowings	$10,000,000
Compensating balances per bank balances	2,000,000
Estimated float (approximates the excess of outstanding checks over deposits in transit)	480,000
Estimated uncollected funds	320,000
Computation:	
Compensating balances per bank balances	2,000,000
Estimated uncollected funds	320,000
Estimated float	(480,000)
Compensating balances stated in terms of a book cash balance and to be disclosed	$ 1,840,000

4. Miscellaneous

a. Periods required

Question: For what periods are ASR 148 disclosures required?

Interpretive Response: Disclosure of compensating balance arrangements and other disclosures called for in ASR 148 are required for the latest fiscal year but are generally not required for any later interim period unless a material change has occurred since year end.

b. 10-Q Disclosures

Question: Are ASR 148 disclosures required in 10-Q's?

Interpretive Response: In general, ASR 148 disclosures are not required in Form 10-Q. However, in some instances material changes in borrowing arrangements or borrowing levels may give rise to the need for disclosure either in Form 10-Q or Form 8-K.

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Question	Yes	No	Disclosure Requirement Met?	Reference
2. Does the company have cash deposits in connection with repurchase agreements?	_____	_____	_____	_____

Disclosure Requirements

Disclose cash deposits in connection with repurchase agreements as restricted cash.

Reference: Regulation S-X, Rule 4-08(m)(1)(iii) (Rule 4-08 is reproduced in ASC 235, Notes to Financial Statements (ASC 235-10-S99-1))

Regulation S-X, Rule 4-08(m)(1)(iii)

Rule 4-08: General Notes to Financial Statements

(m) REPURCHASE AND REVERSE REPURCHASE AGREEMENTS.

(1) Repurchase agreements (assets sold under agreements to repurchase).

(i) If, as of the most recent balance sheet date, the carrying amount (or market value, if higher than the carrying amount or if there is no carrying amount) of the securities or other assets sold under agreements to repurchase ("repurchase agreements") exceeds 10 percent of total assets, disclose separately in the balance sheet the aggregate amount of liabilities incurred pursuant to repurchase agreements including accrued interest payable thereon.

(ii) (A) If, as of the most recent balance sheet date, the carrying amount (or market value, if higher than the carrying amount) of securities or other assets sold under repurchase agreements, other than securities or assets specified in (1)(ii)(B) of this section, exceeds 10 percent of total assets, disclose in an appropriately captioned footnote containing a tabular presentation, segregated as to type of such securities or assets sold under agreements to repurchase (e.g., U.S. Treasury obligations, U.S. Government agency obligations and loans), the following information as of the balance sheet date for each such agreement or group of agreements (other than agreements involving securities or assets specified in (1)(ii)(B) of this section) maturing (1) overnight; (2) term up to 30 days; (3) term of 30 to 90 days; (4) term over 90 days, and (5) demand:

(i) The carrying amount and market value of the assets sold under agreement to repurchase, including accrued interest plus any cash or other assets on deposit under the repurchase agreements; and

(ii) The repurchase liability associated with such transaction or group of transactions and the interest rate(s) thereon.

(B) For purposes of (1)(ii)(A) of this section only, do not include securities or other assets for which unrealized changes in market value are reported in current income or which have been obtained under reverse repurchase agreements.

(iii) If, as of the most recent balance sheet date, the amount at risk under repurchase agreements with any individual counterparty or group of related counterparties exceeds 10 percent of stockholders' equity (or in the case of investment companies, net asset value), disclose the name of each such counter party or group of related counterparties, the amount at risk with each, and the weighted average maturity of the repurchase agreements with each. The amount at risk under repurchase agreements is defined as the excess of carrying amount (or market value, if higher than the carrying amount or if there is no carrying amount) of the securities or other assets sold under agreement to repurchase, including accrued interest plus any cash or other assets on deposit to secure the repurchase obligation, over the amount of the repurchase liability (adjusted for accrued interest). (Cash deposits in connection with repurchase agreements shall not be reported as unrestricted cash pursuant to Rule 5-02-1.)

(2) Reverse repurchase agreements (assets purchased under agreements to resell).

(i) If, as of the most recent balance sheet date, the aggregate carrying amount of "reverse repurchase agreements" (securities or other assets purchased under agreements to resell) exceeds 10 percent of total assets: (A) disclose separately such amount in the balance sheet; and (B) disclose in an appropriately captioned footnote: (1) the registrant's policy with regard to taking possession of securities or other assets purchased under agreements to resell; and (2) whether or not there are any provisions to ensure that the market value of the underlying assets remains sufficient to protect the registrant in the event of default by the counterparty and, if so, the nature of those provisions.

(ii) If, as of the most recent balance sheet date, the amount at risk under reverse repurchase agreements with any individual counterparty or group of related counterparties exceeds 10 percent of stockholders' equity (or in the case of investment companies, net asset value), disclose the name of each such counterparty or group of related counterparties, the amount at risk with each, and the weighted average maturity of the reverse repurchase agreements with each. The amount at risk under reverse repurchase agreements is defined as the excess of the carrying amount of the reverse

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repurchase agreements over the market value of assets delivered pursuant to the agreements by the counterparty to the registrant (or to a third party agent that has affirmatively agreed to act on behalf of the registrant) and not returned to the counterparty, except in exchange for their approximate market value in a separate transaction.

CHAPTER 3 ACCOUNTS AND NOTES RECEIVABLE

INTRODUCTION

Receivables from customers, related parties, and others must be set forth separately in the balance sheet under Regulation S-X, 5-02-3. If the aggregate amount of notes receivable exceeds 10% of the aggregate amount of receivables, a breakdown of notes and accounts must be reflected on the balance sheet or in the footnotes. For commercial and industrial companies, the portion of installment receivables classified as current assets that are due after one year and, if practicable, the amounts maturing in each year should be disclosed.

Regulation S-X, Rule 5-02-4, requires that the amount of the allowance for uncollectible accounts be provided. The SEC staff prohibits valuation accounts from being aggregated and presented on a separate stand-alone basis in the balance sheet. The allowance for loan losses or bad debts is defined as a valuation account that relates to loans or receivables, and the SEC staff requires presentation of the allowance as a reduction of the carrying amount of those loans or receivables.

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Question	Yes	No	Disclosure Requirement Met?	Reference
1. Does the company have accounts and notes receivable?	___	___	___	___

Disclosure Requirements

State separately on the face of the balance sheet, amounts receivable from:

1. Customers;
2. Related parties;
3. Underwriters, promoters, and employees; and
4. Others.

If total notes receivable exceed 10% of total receivables, state the above amounts for accounts receivable and notes receivable separately, either on the face of the balance sheet or in the notes.

Reference: Regulation S-X, Rules 5-02-3(a) and (b) (Rule 5-02 is reproduced in FASB Accounting Standards Codification™ (ASC) 210, Balance Sheet (ASC 210-10-S99-1))

Regulation S-X, Rules 5-02-3(a) and (b)

Rule 5-02: Balance Sheets

3. ACCOUNTS AND NOTES RECEIVABLE.

(a) State separately amounts receivable from (1) customers (trade); (2) related parties (see Rule 4-08(k)); (3) underwriters, promoters, and employees (other than related parties) which arise in other than the ordinary course of business; and (4) others.

(b) If the aggregate amount of notes receivable exceeds 10 percent of the aggregate amount of receivables, the above information shall be set forth separately, in the balance sheet or in a note thereto, for accounts receivable and notes receivable.

Question	Yes	No	Disclosure Requirement Met?	Reference
2. Does the company have loans or other receivables covered by buyback provisions?	___	___	___	___

Disclosure Requirements

In a circumstance where the seller regains control of assets previously accounted for as sold under ASC 860, *Transfers and Servicing*, the original balance sheet classification of the assets should be maintained when control over that asset is re-recognized by the transferor.

Reference: Current Accounting and Disclosure Issues in the Division of Corporation Finance, 11/30/06, II.Q.1

[*Editor's note*: The following excerpted text has not been updated to reflect the ASC.]

Current Accounting and Disclosure Issues in the Division of Corporation Finance, 11/30/06, II.Q.1

II. Other Current Accounting and Disclosure Issues

Q. LOANS AND OTHER RECEIVABLES

1. Accounting for Loans or Other Receivables Covered by Buyback Provisions

The terms of sale of loans or other receivables, including, but not limited to, those securitized through the Government National Mortgage Association or another GSE, may either require or allow for the transferor's repurchase of such loans or receivables upon an event of default.

Paragraph 55 of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, a replacement of FASB Statement No. 125*, specifies the accounting in a circumstance where the seller regains control of assets previously accounted for appropriately as having been sold, such as in the case of a call option that becomes exercisable upon the event of borrower default. The assets should be accounted for in the same manner as a purchase of the assets from the former transferee in exchange for liabilities assumed. Specifically, the transferor recognizes in its financial statements those assets together with liabilities to the former transferees or beneficial interest holders in those assets at fair value on the date that the call becomes exercisable, regardless of whether it intends to exercise the call. EITF Issue 02-9 further clarifies the accounting for a transferor's rerecognition of assets pursuant to paragraph 55 of FASB Statement No. 140.

The original balance sheet classification of the asset when originally transferred should be maintained when control over that asset is re-recognized by the transferor. For instance, if the asset subject to the call or repurchased by the

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transferor is a loan, the balance sheet classification by the transferor upon rerecognition should be Loans, not Other Assets. No loan loss allowance should be recorded upon initial re-recognition of loans at fair value. Subsequent accounting for the re-recognized loan will depend on whether the loans are classified as held for investment or held for sale.

In the event that loans re-recognized by the transferor have the risk elements contemplated by Item III.C.1. of Industry Guide 3 (i.e., nonaccrual, past due, restructured), the amount of such loans should be included in the disclosures required by that Item. Supplemental disclosures may be made to facilitate understanding of the aggregate amounts reported pursuant to Item III.C.1. These disclosures may include, for example, information as to the nature of the loans, any guarantees, the extent of collateral, or amounts in process of collection. For example, if a loan re-recognized by a transferor is accruing, but it is contractually past due 90 days or more as to principal or interest, that loan should be included in the disclosure required by Item III.C.1(b) even if the loan is guaranteed through a government program, such as the Veterans Administration (VA) or Federal Housing Authority (FHA).

Question	Yes	No	Disclosure Requirement Met?	Reference
3. Does the company have receivables from officers, directors, parents, or affiliates?	____	____	____	____

Disclosure Requirements

Certain receivables from officers, directors, the parent, or affiliates must be shown as a deduction from stockholders' equity. See SAB Topics 4E and 4G for details.

Reference: SAB Topics 4E and 4G (SAB Topic 4E is reflected in the ASC at ASC 310, Receivables (ASC 310-10-S99-2), and SAB Topic 4G is reflected in the ASC at ASC 310-10-S99-3)

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SAB Topics 4E and 4G

SAB Topic 4: Equity Accounts

E. RECEIVABLES FROM SALES OF STOCK

Facts: Capital stock is sometimes issued to officers or other employees before payment is received.

Question: How should the receivables from the officers or other employees be presented in the balance sheet?

Interpretive Response: The amounts recorded as a receivable should be presented in the balance sheet as a deduction from stockholders' equity. This is generally consistent with Rule 5-02-30 of Regulation S-X which states that accounts or notes receivable arising from transactions involving the registrant's capital stock should be presented as deductions from stockholders' equity and not as assets.

It should be noted generally that all amounts receivable from officers and directors resulting from sales of stock or from other transactions (other than expense advances or sales on normal trade terms) should be separately stated in the balance sheet irrespective of whether such amounts may be shown as assets or are required to be reported as deductions from stockholders' equity. The staff will not suggest that a receivable from an officer or director be deducted from stockholders' equity if the receivable was paid in cash prior to the publication of the financial statements and the payment date is stated in a note to the financial statements. However, the staff would consider the subsequent return of such cash payment to the officer or director to be part of a scheme or plan to evade the registration or reporting requirements of the securities laws.

Facts: Capital stock is sometimes issued to officers or other employees before the cash payment is received.

Question: How should the receivables from the officers or other employees be presented in the balance sheet?

Interpretive Response: The amount recorded as a receivable should be presented in the balance sheet as a deduction from stockholders' equity. This is generally consistent with Rule 5-02.30 of Regulation S-X which states that accounts or notes receivable arising from transactions involving the registrant's capital stock should be presented as deductions from stockholders' equity and not as assets.

It should be noted generally that all amounts receivable from officers and directors resulting from sales of stock or from other transactions (other than expense advances or sales on normal trade terms) should be separately stated in the balance sheet irrespective of whether such amounts may be shown as assets or are required to be reported as deductions from stockholders' equity.

The staff will not suggest that a receivable from an officer or director be deducted from stockholders' equity if the receivable was paid in cash prior to the publication of the financial statements and the payment date is stated in a note to the financial statements. However, the staff would consider the subsequent return of such cash payment to the officer or director to be part of a scheme or plan to evade the registration or reporting requirements of the securities laws.

G. NOTES AND OTHER RECEIVABLES FROM AFFILIATES

Facts: The balance sheet of a corporate general partner is often presented in a registration statement. Frequently, the balance sheet of the general partner discloses that it holds notes or other receivables from a parent or another affiliate. Often the notes or other receivables were created in order to meet the "substantial assets" test which the Internal Revenue Service utilizes in applying its "Safe Harbor" doctrine in the classification of organizations for income tax purposes.

Question: How should such notes and other receivables be reported in the balance sheet of the general partner?

Interpretive Response: While these notes and other receivables evidencing a promise to contribute capital are often legally enforceable, they seldom are actually paid. In substance, these receivables are equivalent to unpaid subscriptions receivable for capital shares, which Rule 5-02-30 of Regulation S-X requires to be deducted from the dollar amount of capital shares subscribed.

The balance sheet display of these or similar items is not determined by the quality or actual value of the receivable or other asset "contributed" to the capital of the affiliated general partner, but rather by the relationship of the parties and the control inherent in that relationship. Accordingly, in these situations, the receivable must be treated as a deduction from stockholders' equity in the balance sheet of the corporate general partner.

Question	Yes	No	Disclosure Requirement Met?	Reference
4. Does the company have receivables due under long-term contracts?	___	___	___	___

Disclosure Requirements

State separately on the balance sheet or in a note to the financial statements the following amounts:

1. Balances billed but not paid by customers under retainage provisions in contracts.
2. Amounts representing the recognized sales value of performance and such amounts that had not been billed and were not billable to customers at the date of the balance sheet. Include a general description of the prerequisites for billing.
3. Billed or unbilled amounts representing claims or other similar items subject to uncertainty concerning their determination or ultimate realization. Include a description of the nature and status of the principal items comprising such amount.
4. With respect to (1) through (3) above, also state the amounts included in each item that are expected to be collected after one year. Also state, by year, if practicable, when the amounts of retainage (see (1) above) are expected to be collected.

References: Regulation S-X, Rules 5-02-3(c) and 5-02-6(d); FRR 206 (Rule 5-02 is reproduced in ASC 210-10-S99-1)

Regulation S-X, Rules 5-02-3(c) and 5-02-6(d); FRR 206

Rule 5-02: Balance Sheets

3. ACCOUNTS AND NOTES RECEIVABLE

(c) If receivables include amounts due under long-term contracts (see Rule 5-02-6(d)), state separately in the balance sheet or in a note to the financial statements the following amounts:

(1) Balances billed but not paid by customers under retainage provisions in contracts.

(2) Amounts representing the recognized sales value of performance and such amounts that had not been billed and were not billable to customers at the date of the balance sheet. Include a general description of the prerequisites for billing.

(3) Billed or unbilled amounts representing claims or other similar items subject to uncertainty concerning their determina-

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tion or ultimate realization. Include a description of the nature and status of the principal items comprising such amount.

(4) With respect to (1) through (3) above, also state the amounts included in each item which are expected to be collected after one year. Also state, by year, if practicable, when the amounts of retainage (see (1) above) are expected to be collected.

6. INVENTORIES

(d) For purposes of Rules 5-02-3 and 5-02-6, long-term contracts or programs include (1) all contracts or programs for which gross profits are recognized on a percentage-of-completion method of accounting or any variant thereof (e.g., delivered unit, cost to cost, physical completion), and (2) any contracts or programs accounted for on a completed contract basis of accounting where, in either case, the contracts or programs have associated with them material amounts of inventories or unbilled receivables and where such contracts or programs have been or are expected to be performed over a period of more than twelve months. Contracts or programs of shorter duration may also be included, if deemed appropriate.

For all long-term contracts or programs, the following information, if applicable, shall be stated in a note to the financial statements:

(i) The aggregate amount of manufacturing or production costs and any related deferred costs (e.g., initial tooling costs) which exceeds the aggregate estimated cost of all in-process and delivered units on the basis of the estimated average cost of all units expected to be produced under long term contracts and programs not yet complete, as well as that portion of such amount which would not be absorbed in cost of sales based on existing firm orders at the latest balance sheet date. In addition, if practicable, disclose the amount of deferred costs by type of cost (e.g., initial tooling, deferred production, etc.).

(ii) The aggregate amount representing claims or other similar items subject to uncertainty concerning their determination or ultimate realization, and include a description of the nature and status of the principal items comprising such aggregate amount.

(iii) The amount of progress payments netted against inventory at the date of the balance sheet.

206. Disclosures Related to Defense and Other Long-Term Contract Activities

ASR 164

206.01. Introduction

The Commission has long been concerned about the quality of disclosures made by registrants engaged in defense and other long-term contract activities because these activities involve inventories and receivables with unique risk and liquidity characteristics. The Commission believes that it is necessary and appropriate to require disclosure of greater detail in certain critical areas of long-term

contract activity, particularly with respect to the nature of costs accumulated in inventories, the effect of cost accumulation policies on cost of sales, and the effect of revenue recognition practices on receivables and inventories.

206.02. Disclosures in Financial Statements

a. Disclosure Regarding Receivables

i. Retainage

Due to the unique liquidity characteristics of retainage, the Commission believes that any material amount of retainage should be disclosed no matter when such amount is expected to be collected. However, the Commission also believes that the significant uncertainties which often affect the determination of a mutually satisfactory contract completion may cause the estimates of amounts to be collected within specific years to become progressively less reliable. Consequently, Rule 5-02-3(c)(1) of Regulation S-X requires the isolation of only the aggregate amount of retainage expected to be collected after one year. However, registrants are encouraged to provide estimated collections by year if their experience or other factors enable them to do so with reasonable accuracy.

The Commission believes that it is unnecessary for the rule to provide specifically for amounts retained by contractors pursuant to the provisions of subcontracts because Rule 5-02-25 can be interpreted to require separate disclosure of significant amounts of retentions payable to subcontractors.

206.02.a.ii. Unbilled Amounts

Rule 5-02.3(c)(2) calls for disclosure of the amounts of receivables not billed or billable that are expected to be collected after one year. The Commission believes that disclosure of the timing of expected collections provides investors with meaningful liquidity and risk information. It should be noted that the rule is not directed at items which are "unbilled" at the balance sheet date merely because the necessary paperwork has not been processed in accordance with the normal operation of a billing system. Such items would generally be considered "billable" for purposes of this rule.

206.02.a.iii. Claims and Similar Items

The Commission believes that amounts due under routine change orders and escalation features commonly found in the terms of contracts are typically not subject to such uncertainty that separate disclosure is required. On the other hand, it believes that disclosure is necessary when amounts are recorded which are not reasonably determinable under the specific terms of existing contracts. Accordingly, Rule 5-02-3(c)(3) requires disclosure where the amounts included in receivables whether billed or unbilled, are either claims or other similar items subject to uncertainty concerning their determination or ultimate realization.

206.02.b. Disclosure Regarding Inventories

The Commission expects that the description of the cost elements included in inventory will appropriately disclose the existence of items not typically included in inventoried costs in a usual manufacturing operation. In general, the Commission believes that the accounting treatment of such costs is sufficiently unique to warrant the disclosure of their existence and, to the extent noted below, their magnitude.

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206.02.b.i. Cost Elements Included in Inventories

The Commission recognizes that some registrants may find it impracticable to determine the actual amount of general and administrative costs remaining in inventory at the balance sheet dates. However, the commission believes that registrants can provide reasonable estimates of such remaining costs determined, for example, on the assumption that costs related to a particular contract or program have been removed from inventory on a basis proportional to the totals of the various cost elements expected to be charged to cost of sales for that contract or program. The assumptions used to develop these estimates should be described in a note to the financial statements (see Rule 5-02-6(b)).

206.02.b.ii. Claims and Similar Items

Rule 5-02-6(d)(2)(ii) recognizes that certain registrants classify amounts representing claims or other similar items subject to uncertainties as inventories rather than as receivables reportable under Rule 5-02-3(c). Regardless of where such amounts are classified, the Commission believes that material amounts must be disclosed together with an appropriate description of the nature and status of the principal items comprising such amounts.

206.03. Example

The following hypothetical example is furnished to illustrate the character and detail of the disclosures which might be furnished in response to Rules 5-02-3 and 5-02-6 of Regulation S-X. The illustration is provided to assist in understanding and evaluating the rules.

(000 omitted)	19X4	19X
ASSETS		
CURRENT ASSETS:		
Cash	$ 438	$ 62
Accounts receivable: Trade and other receivables, net of allowance, for uncollectible accounts of $38,000 in 19X4 and $36,000 in 19X3	2,846	2,93
Long-term contracts and programs (notes 1 and 2)	18,985	19,03
Total accounts receivable	$21,831	$21,43
Inventories costs relating to long-term contracts and in process, net of progress payments (notes 1 and 3)	$ 6,278	$ 6,25
Prepaid expenses	46	2
Total current assets	$28,593	$28,34

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

REVENUE RECOGNITION. Sales of commercial products under long-term contracts and programs are recognized in the accounts as deliveries are made. The estimated sales value of performance under Government fixed-price and fixed-price incentive contracts in process is recognized under the percentage of completion method of accounting where under the estimated sales value is determined on the basis of physical completion to date (the total contract amount multiplied by percent of performance to date less sales value recognized in previous periods) and cost (including general and administrative, except as described below) are expensed as incurred. Sales under cost-reimbursement

contracts are recorded as costs are incurred and include estimated earned fees in the proportion that costs incurred to date bear to total estimated costs. The fees under certain Government contracts may be increased or decreased in accordance with cost or performance incentive provisions which measure actual performance against established targets or other criteria. Such incentive fee awards or penalties are included in sales at the time the amounts can be determined reasonably.

INVENTORIES. Inventories, other than inventoried costs relating to long-term contracts and programs, are stated at the lower of cost (principally first-in, first-out) or market. Inventoried costs relating to long-term contracts and programs are stated at the actual production cost, including factory overhead, initial tooling and other related nonrecurring costs, incurred to date reduced by amounts identified with revenue recognized on units delivered or progress completed. General and administrative costs applicable to cost-plus Government contracts are also included in inventories. Inventoried costs relating to long-term contracts and programs are reduced by charging any amounts in excess of estimated realizable value to cost of sales. The costs attributed to units delivered under long-term commercial contracts and programs are based on the estimated average cost of all units expected to be produced and are determined under the learning curve concept which anticipates a predictable decrease in unit costs as tasks and production techniques become more efficient through repetition.

In accordance with industry practice, inventories include amounts relating to contracts and programs having production cycles longer than one year and a portion thereof will not be realized within one year.

NOTE 2. ACCOUNTS RECEIVABLE

The following tabulation shows the component elements of accounts receivable from long-term contracts and programs:

(000 omitted)	19X4	19X3
U.S. Government:		
Amounts billed	$ 7,136	$ 6,532
Recoverable costs and accrued profit on progress completed—not billed	4,173	3,791
Unrecovered costs and estimated profits subject to future negotiation—not billed	1,468	1,735
	$12,777	$12,058
Commercial Customers:		
Amounts billed	1,937	3,442
Recoverable costs and accrued profit on units delivered—not billed	1,293	364
Retainage, due upon completion of contracts	2,441	2,279
Unrecovered costs and estimated profits subject to future negotiation—not billed	537	893
	$18,985	$19,036

The balances billed but not paid by customers pursuant to retainage provisions in construction contracts will be due upon completion of the contracts and acceptance by the owner. Based on the Company's experience with similar contracts in recent years, the retention balances at December 31, 19X4, are

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Recoverable costs and accrued profit not billed comprise principally amounts of revenue recognized on contracts for which billings had not been presented to the contract owners because the amounts were not billable at balance sheet date. It is anticipated such unbilled amounts receivable from the U.S. Government at December 31, 19X4, will be billed over the next 60 days as units are delivered. The unbilled accounts receivable applicable to commercial customers are billable upon completion or performance tests which are expected to be completed in September 19X5.

Unrecovered costs and estimated profits subject to future negotiation, the principal amount of which is expected to be billed and collected within one year, consist of the following elements.

(000 omitted)	19X4	19X
U.S. Government Contracts:		
Excess of estimated or proposed over provisional price	$ 190	$ 15
Amounts claimed for incremental costs arising from customer-occasioned contract delays	1,278	1,57
	1,468	1,73
Commercial Contracts:		
Unrecovered costs and estimated profit relating to work not specified in express contract provision	537	89
	$2,005	$2,62

NOTE 3. INVENTORIES

Inventories and inventoried costs relating to the long-term contracts and programs are classified as follows:

(000 omitted)	December 31 19X4	December 3 19X
Finished goods	$3,562	$3,4
Inventoried costs relating to long-term contracts and programs, net of amounts attributed to revenues recognized to date	2,552	2,63
Work in process	738	94
Raw materials	453	38
Supplies	112	7
	7,417	7,4
Deduct progress payments to long-term contracts and programs	1,139	1,2
	$6,278	$6,2

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The following tabulation shows the cost elements included in inventoried costs relating to long-term contracts.

(000 omitted)	December 31 19X4	December 31 19X3
Production costs of goods currently in process	$1,184	$ 960
Excess of production cost of delivered units over the estimated average cost of all units expected to be produced	647	893
Unrecovered costs subject to future negotiation	280	310
General and administrative costs	260	270
Initial tooling and other non-recurring costs	181	205
	$2,552	$2,638

The inventoried costs relating to long-term contracts and programs includes unrecovered costs of $280,000 and $310,000 at December 31, 19X4, and 19X3, respectively, which are subject to future determination through negotiation or other procedures not completed at balance sheet dates. Of such amounts, $260,000 and $280,000 are in respect to contracts under which all goods have been delivered at December 31, 19X4, and 19X3, respectively. The unrecovered amount at December 31, 19X3 consisted of three items, one of which was settled during 19X4. The amount remaining at December 31, 19X4, is represented principally by a claim asserted against a customer for amounts incurred as a result of faulty materials furnished by the customer which in turn caused delays in performance under the contract. In the opinion of management, these costs will be recovered by contract modification or litigation. It is expected that the negotiations which are being conducted currently with the customer will be successfully concluded during the next 12 months. If this expectation is not realized, the matter will be referred to the Armed Services Board of Contract Appeals, with the consequence that settlement could be delayed for an indeterminate period.

The actual per unit production cost of the NX-4C aircraft produced during the most recent fiscal year was less than the estimated average per unit cost of all units expected to be produced under the program. Prior to 19X4, the Company's NX-4C commercial aircraft program was in the early high cost period. During the initial years of the program, the cost of units produced exceeded the sales price of the delivered units and the estimated average unit cost of all units to be produced under the program. At December 31, 19X4, inventories included costs of $647,000 representing the excess of costs incurred over estimated average costs per aircraft for the 117 aircraft delivered through the year end. The estimated average unit cost is predicated on the assumption that 250 planes will be produced and that production costs (principally labor and materials) will decrease as the project matures and efficiencies associated with increased volume, improved production techniques and the performance of repetitive tasks (the learning curve concept) are realized. (Note: The amount by which the production cost of the equivalent finished units in process at the date of the latest balance sheet exceeds the cost of such units on the basis of the estimated average unit cost of all units expected to be produced under the program should be stated. Since, as stated above, the actual per unit production cost is currently less than the estimated average per unit cost of all units expected to be produced under the program, no such excess is assumed in this example.)

Recovery of the deferred production, initial tooling and related non-recurring costs i dependent on the number of aircraft ultimately sold and actual selling prices a production costs associated with future transactions. Sales significantly under es mates or costs significantly over estimates could result in the realization of substant losses on the program in future years. Realization of approximately $421,000 of t gross commercial aircraft inventories at December 31, 19X4, is dependent on recei of future firm orders.

Based on studies made by and on behalf of the Company, management believ there exists for this aircraft a market for over 250 units, including deliveries to da with production and deliveries continuing at a normal rate to at least 19Y0. December 31, 19X4, 117 aircraft had been delivered under the program, and t backlog included 64 firm unfilled orders and options for 43 units.

The aggregate amounts of general and administrative costs incurred during 19X4 a 19X3 were $2,251,000 and $2,238,000, respectively. As stated in Note 1, the Co pany allocates general and administrative costs to certain types of Governme contracts. The amounts of general and administrative costs remaining in inventori at December 31, 19X4, and 19X3 are estimated at $260,000 and $270,000, respe tively. Such estimates assume that costs have been removed from inventories on basis proportional to the amounts of each cost element expected to be charged cost of sales.

Question	Yes	No	Disclosure Requirement Met?	Reference
5. Does the company have allowances for doubtful accounts and (or) notes receivable?	___	___	___	___

Disclosure Requirements

State separately the amount of allowance for doubtful accounts and notes receivable.

Reference: Regulation S-X, Rule 5-02-4 (Rule 5-02 is reproduced in ASC 210-10-S99-1)

Describe clearly and comprehensively the accounting policy for determining the amount of the allowance, including a description of the systematic analysis and procedural discipline applied.

Reference: Current Accounting and Disclosure Issues in the Division of Corporation Finance, 11/30/06, 11.P.1

[*Editor's note*: The following excerpted text has not been updated to reflect the ASC.]

Regulation S-X, Rule 5-02-4; Current Accounting and Disclosure Issues in the Division of Corporation Finance, 11/30/06, II.P.1

Rule 5-02: Balance Sheets

4. ALLOWANCES FOR DOUBTFUL ACCOUNTS AND NOTES RECEIVABLE.

The amount is to be set forth separately in the balance sheet or in a note thereto.

Current Accounting and Disclosure Issues in the Division of Corporation Finance, 11/30/06, II.P.1

II. Other Current Accounting and Disclosure Issues

P. ALLOWANCE FOR LOAN LOSSES

1. Disclosure

The determination of the allowance for loan losses requires significant judgment. The balance in the allowance for loan losses should reflect management's best estimate of probable loan losses related to specifically identified loans as well as probable incurred loan losses in the remaining loan portfolio. SFAS 5 and FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, limit loss allowances to losses that have been incurred as of the balance sheet date. Accordingly, allowances for loan losses should be based on past events and current economic conditions. Disclosures that explain the allowance in terms of potential, possible, or future losses, rather than probable losses, suggest a lack of compliance with GAAP and are not appropriate.

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Accounting Principles Board Opinion No. 22, *Disclosure of Accounting Policies*, sets forth the general requirements for accounting policy disclosures in the financial statements. Industry Guide 3 specifies additional detail that should be provided in explanation of loss allowances within the Description of Business. Viewed together, these disclosures should describe in a comprehensive and clear manner the registrant's accounting policies for determining the amount of the allowance in a level of detail sufficient to explain and describe the systematic analysis and procedural discipline applied. Registrants commonly develop different elements in their allowances to estimate (1) losses based upon specific evaluations of known loss on individual loans, (2) estimated unidentified losses on various pools of loans and/or groups of graded loans, and (3) other elements of estimated probable losses based on other facts and circumstances. The disclosures should describe and quantify each element of the allowance, and explain briefly how the registrant's procedural discipline was applied in determining the amount, and not simply the "adequacy," of each specific element. If loans are grouped by pool or by grading within type to estimate unidentified probable losses, the basis for those groupings and the methods for determining loss factors to be applied to those groupings should be described. The basis for estimating the impact of environmental factors, such as local and national economic conditions and trends in delinquencies and losses, whether through modifying loss factors or through a separate allowance element, should be disclosed. Changes in methodology and their impact should be disclosed in accordance with Accounting Principles Board Opinion No. 20, *Accounting Changes*.

MD&A should explain the period-to-period changes in specific elements of the allowance. It also should discuss the extent to which actual experience has differed from original 53 estimates. The reasons for changes in management's estimates should indicate what evidence management relied upon to determine that the revised estimates were more appropriate and how those revised estimates were determined. A registrant following a procedural discipline should be recording provisions for loan losses that reflect the changes in asset quality as measured in the registrant's periodic loan reviews. MD&A should discuss the reasons for the changes in assets quality and explain how those changes have affected the allowance and provision. If historical loss experience appears low or high relative to the level of the allowance at the latest balance sheet date, a reconciling explanation should be provided. If a registrant changes its methodology, the basis for changing its methodology and the effects of the change should be explained.

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Question	Yes	No	Disclosure Requirement Met?	Reference
6. Does the company have a receivable relating to litigation settlement?	___	___	___	___

Disclosure Requirements

Describe the reason for a litigation settlement receivable and where the credit has been classified in the statement of operations and why.

Reference: SEC Speech, West 2007

[*Editor's note*: The following excerpted text has not been updated to reflect the ASC.]

SEC Speech, West 2007

Speech by SEC Staff

Remarks before the 2007 AICPA National Conference on Current SEC and PCAOB Developments

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Washington, D.C.

December 10, 2007

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Introduction

This afternoon I'd like to share some observations on three accounting topics that we have considered during the past year. They include: the accounting for litigation settlements; the recognition of FIN 45 guarantees in a spin-off transaction; and the application of paragraph 17c of SFAS 141.

Accounting for Litigation Settlements

During the past year we have been consulted by many registrants on the accounting for litigation settlements. Your initial reaction to this statement is likely to be "why" since the accounting for litigation is within the scope of Statement 5 and is fairly well known. Well, to demonstrate the challenges that can arise with the accounting for litigation settlements, I'd like to share a typical settlement arrangement with you. Assume a company pays cash and conveys licenses to a

CHAPTER 17
BANKRUPTCY

Question	Yes	No	Disclosure Requirement Met?	Reference
1. Is the company reorganizing under the U.S. Bankruptcy Code?	____	____	____	____

Disclosure Requirements

Disclose the extent to which reported interest differs from stated contractual interest (disclose parenthetically on the face of the statement of operations).

If it is probable that the plan will require the issuance of common stock or common stock equivalents, thereby diluting current equity interests, that fact should be disclosed.

References: FASB Accounting Standards Codification™ (ASC) 852, Reorganizations (ASC 852-10-45-16 and ASC 852-10-50-3)

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ASC 852-10

ASC 852-10-45-16

EPS

45-16 Earnings per share (EPS) shall be reported, if required, in conformity with Topic 260. If it is probable that the plan will require the issuance of common stock or common stock equivalents, thereby diluting current equity interests, that fact shall be disclosed.

ASC 852-10-50-3

FINANCIAL REPORTING DURING REORGANIZATION PROCEEDINGS

. . .

50-3 The extent to which reported interest expense differs from stated contractual interest shall be disclosed. It may be appropriate to disclose this parenthetically on the face of the statement of operations.

Question	Yes	No	Disclosure Requirement Met?	Reference
2. Does the company consolidate a subsidiary that is in bankruptcy?	____	____	____	____

Disclosure Requirements

The SEC staff believes a determination that continued consolidation of a subsidiary in bankruptcy requires a fairly unique set of facts and is appropriate only in infrequent and uncommon circumstances. The conclusion to consolidate and its basis should be disclosed. The company should periodically reassess its facts and circumstances to confirm the appropriateness of such a determination.

Reference: SEC Speech, Green 2003

[*Editor's note*: The following excerpted text has not been updated to reflect the ASC.]

SEC Speech, Green 2003

Speech by SEC Staff

2003 Thirty-First AICPA National Conference on Current SEC Developments

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Washington, D.C.

December 11, 2003

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Accounting for a Temporary Loss of Control

Paragraph 13 of Statement 94[1] indicates that "a majority owned subsidiary shall not be consolidated if control does not rest with the majority owner (as, for instance, if the subsidiary is in legal reorganization or in bankruptcy . . .)." I think most would conclude that bankruptcy is indicative of a loss of control and that deconsolidation is appropriate. However, paragraph 32 of SOP 90-7[2] suggests that there are conditions in which the continued consolidation of a subsidiary in bankruptcy is appropriate.

[1] Statement of Financial Accounting Standard No. 94, *Consolidation of All Majority-Owned Subsidiaries* (an Amendment of ARB No. 51, with Related Amendments of APB Opinion No. 18 and ARB No. 43, Chapter 12).

[2] American Institute of Certified Public Accountants Statements of Position (SOP) 90-7, *Financial Reporting by Entities in Reorganization under the Bankruptcy Code*.

Recently, we were asked to consider whether the deconsolidation of a majority-owned subsidiary in bankruptcy was appropriate. We were willing to undertake such a consideration because, in part, we believe that, even when a subsidiary is in bankruptcy, there are circumstances where the continued consolidation of a subsidiary is more meaningful. For example, consider an instance where the parent has a negative investment, expects the bankruptcy to be brief, and expects further to regain control of the subsidiary. One might be appropriately concerned about the deconsolidation, recognition of a gain, and reconsolidation of a subsidiary by a parent in a short period of time.

In the fact pattern we considered, the parent was the majority common shareholder, a priority debt holder, and the subsidiary's single largest creditor. Due to its creditor position, the parent was able to negotiate a prepackaged bankruptcy with the subsidiary's other creditors. The parent, pursuant to the terms of the prepackaged bankruptcy, expected to maintain majority-voting control after the bankruptcy. The parent also expected the bankruptcy to be completed in less than one year.

While we are inclined to continue to believe that bankruptcy is indicative of the fact that control does not rest with the majority owner, we did not object to the parent's determination that the continued consolidation of its subsidiary during bankruptcy was more meaningful and that any loss of control would be temporary given the facts and circumstances.

Obviously, a determination that continued consolidation of a subsidiary in bankruptcy is appropriate requires a fairly unique set of facts and is appropriate only in infrequent and uncommon circumstances. It is not a conclusion that a registrant should make without thoroughly consulting with its auditors and one the company should consider discussing with us. In any event, the conclusion and its basis should be adequately disclosed and the company should periodically reassess its facts and circumstances to confirm the appropriateness of such a determination.

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CHAPTER 18 BUSINESS COMBINATIONS

INTRODUCTION

Essentially, a business combination is a merger, acquisition, or other consolidation. A business combination occurs when an entity acquires net assets that constitute a business, or acquires equity interests in one or more other entities that are businesses and obtains control over those entities. A business can be defined as a self-sustaining set of activities and assets conducted and managed for the purpose of providing a return to investors. The purchase price of the acquired company is allocated to the net assets obtained, and the incomes of the entities are combined only for periods after the acquisition date, with the income of the acquired company adjusted to recognize the revised net asset values.

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Question	Yes	No	Disclosure Requirement Met?	Reference
1. Has the company acquired, or is it in the process of acquiring, a significant business as defined by Regulation S-X, Rule 3-05?	____	____	________	____

Disclosure Requirements

Rule 3-05 requires separate audited balance sheets as of the end of up to the latest two fiscal years, an unaudited condensed balance sheet for the latest interim period, audited statements of income and cash flows for periods of up to three years, and separate comparable unaudited condensed statements for any interim periods for the following:

1. Significant business acquired during the latest fiscal year or subsequent interim period (includes the purchase of an interest in a business accounted for by the equity method).
2. Significant business to be acquired after the latest interim period (when such action is probable).

Requirements by Filing

Financial statements of a business acquired or to be acquired are not required in Form 10-K, Form 10-Q, or annual reports to shareholders.

The financial statements of an acquired business that is significant are required in:

1. A Form 8-K filing;
2. A registration statement; and
3. In certain cases, a proxy statement.

The financial statements of a business to be acquired (i.e., a probable acquisition) that is significant, as well as financial statements for individually insignificant acquisitions that are material in the aggregate, are required in:

1. A registration statement; and
2. In certain cases, a proxy statement.

Definition of Significance

The SEC's rules define significance using the three quantitative tests of Regulation S-X, Rule 1-02(w), that are based on the size of the entity acquired or to be acquired relative to the size of the registrant. These tests are based on:

1. *Investment or purchase price test*—The registrant's and its subsidiaries' investments in and advances to the business being acquired relative to the total assets of the registrant and its subsidiaries consolidated as of the end of the most recently completed fiscal year. For business combinations, this test measures the significance of the total purchase price, including debt assumed.
2. *Asset test*—The registrant's and its other subsidiaries' proportionate share of the total assets (after intercompany eliminations) of the business being acquired or disposed of relative to the total assets of the registrant and its subsidiaries consolidated as of the end of the most recently completed fiscal year.
3. *Pretax income test*—The registrant's and its other subsidiaries' proportionate share (equity) in the income from continuing operations before income taxes, extraordinary items, and cumulative effect of a change in accounting principles of the business being acquired or disposed of, exclusive of amounts attributable to any noncontrolling interests, relative to the total pretax income (similarly defined) of the registrant and its subsidiaries consolidated for the most recently completed fiscal year. The registrant may use the average of its pretax income for the past five years in this test when the most recent year's pretax income is at least 10% lower than average pretax income for the most recent five years. However, the pretax income of the business being acquired may not be averaged. If either the registrant or the acquiree has been in existence for less than one year, historical financial statements should not be annualized.

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In December 2010, an update to the Division of Corporation Finance's Financial Reporting Manual was issued to provide guidance on significance testing. Specifically, this update removed the prohibition on using income averaging to measure significance if a pre-tax loss occurred in the most recent fiscal year. Further, on December 7, 2010, the Corp Fin staff gave a presentation on how to apply the revised guidance when testing for significance.

Financial Statements to Be Presented

The lowest level of significance for which financial statements of a business acquired or to be acquired are required is 20%. The larger the relative significance of the entity acquired or to be acquired, the more extensive the financial statement requirements.

Level of Significance	*Number of Periods*
None of the tests exceeds 20%	None
Any one of the tests exceeds 20% but none exceeds 40%	Most recent fiscal year[a]
Any one of the tests exceeds 40% but none exceeds 50%	Two most recent fiscal years[a,b]
Any one of the tests exceeds 50%	Three most recent fiscal years[a,c]

[a] Unaudited interim financial statements, including financial statements for the corresponding interim period of the preceding year, may also be required.
[b] Balance sheets and statements of income, cash flows, and changes in shareholders' equity for the two most recent years are required.
[c] Balance sheets for the two most recent fiscal years and statements of income, cash flows, and changes in shareholder's equity for three years are required.

Definition of a Business

Rule 3-05 applies to the acquisition of a business, not to the acquisition of an asset. In some situations, it is not clear whether the acquisition is of a business or of assets. Regulation S-X, Rule 11-01(d) indicates that a presumption exists that a separate entity, e.g., a subsidiary or division, is a business. A lesser component of an entity may also constitute a business, depending on facts and circumstances.

In practice, the SEC staff uses a broad definition of "business" and in most cases requires statements, even if only a product line, or, as indicated in Rule 3-05, an investment accounted for under the equity method is acquired. Also, whether the net assets or capital stock of an operation is acquired makes no difference if the operation is deemed to be a business.

The following transactions may also constitute the acquisition of a business:

- Acquisition of a working interest in an oil and gas property
- Assumption of customer deposits at branch banks
- Acquisitions of blocks of insurance policies by an insurance company
- Assumption of policy liabilities in reinsurance transactions

Definition of Probable

Statements for "to be acquired" or proposed acquisitions are required when consummation of the transaction is probable. This is generally when an agreement in principle has been reached or the boards of directors of both companies have approved the transaction, even though the transaction may be subject to shareholder approval or other uncertainties. The SEC's rules do not include a specific definition for a "probable acquisition." The Division of Corporation Finance, *Financial Reporting Manual*, Section 2005.4: Definitions and Requirements—"Probable," states that, "assessment of 'probability' requires consideration of all available facts" and that an acquisition is probable where registrant's financial statements alone would not provide adequate financial information to make an investment decision."

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Determining Significance

The SEC staff has provided its views on applying the various significance tests. These views are reflected in Section 2015 of the Division of Corporation Finance's Financial Reporting Manual.

Related Businesses

Rule 3-05 of Regulation S-X requires that related businesses be treated as a single business when measuring significance. The SEC staff has provided guidance on this requirement in Section 2020.8 of the Division of Corporation Finance's *Financial Reporting Manual*. In general, if the significance test in Rule 3-05 is met, separate financial statements of each of the related businesses are required, except that financial statements of the related businesses that are under common control or management may be, but are not required to be, presented on a combined basis for any annual or interim periods specified in Rule 3-05 for which the businesses are under common control or management. The SEC staff has indicated that if a registrant believes that application of the significance tests results in a requirement to present financial statements of one or more related businesses, but that it is not reasonably necessary to inform investors, the registrant may make a request for relief from this requirement from the Division of Corporation Finance.

Smaller Reporting Companies

Rule 8-04 outlines the financial statements of the business acquired or to be acquired to be furnished when the acquirer is a smaller reporting company, as defined by Regulation S-K Item 10(f)(1). Such requirements are less restrictive than those outlined above.

Step Acquisitions

The SEC staff has provided its views on applying the significance tests when a registrant makes a step acquisition by increasing its investment in a company that is already reflected as a consolidated subsidiary in the audited financial statements of the registrant for a complete fiscal year. These SEC staff views are provided in the Division of Corporation Finance's Financial Reporting Manual, Section 2020.5. Examples of when historical financial statements of an acquired business may be required for a step acquisition include:

- When the acquired business financial statements have not been previously filed for the entire period for which historical financial statements of the acquired entity would be required under Regulation S-X 3-05;
- When the acquired business is of major significance; or
- When Regulation S-X 3-05 does not apply, such as when a proxy statement or Form S-4 requirement to present the target's financial statements for the same periods that would be required in an annual report sent to security holders, if an annual report was required.

References: Regulation S-X, Rules 3-05, 1-02(w), 8-04, 8-05, and 11-01; SAB Topic 1J; Division of Corporation Finance, Financial Reporting Manual, Sections 1170, 2005.4, 2015, and 2020.5; Current Developments in the Division of Corporation Finance, December 7, 2010 (Slides 27-38) (not reproduced) Division of Corporation Finance, Financial Reporting Manual, Section 2020.8: Significance Implementation—Related Businesses-General

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Regulation S-X, Rules 3-05, 1-02(w), 8-04, 8-05, and 11-01; SAB Topic 1J; Division of Corporation Finance, *Financial Reporting Manual*, Sections 1170, 2005.4, 2015, 2020.5, and 2020.8

Rule 3-05: Financial Statements of Businesses Acquired or to Be Acquired

(a) Financial statements required.

(1) Financial statements prepared and audited in accordance with this regulation should be furnished for the periods specified in (b) below if any of the following conditions exist:

(i) A business combination has occurred or is probable (for purposes of this section, this encompasses the acquisition of an interest in a business accounted for by the equity method); or

(ii) Consummation of a combination between entities under common control is probable.

(2) For purposes of determining whether the provisions of this rule apply, the determination of whether a "business" has been acquired should be made in accordance with the guidance set forth in Rule 11-01 (d).

(3) Acquisitions of a group of related businesses that are probable or that have occurred subsequent to the latest fiscal year-end for which audited financial statements of the registrant have been filed shall be treated under this section as if they are a single business combination. The required financial statements of related businesses may be presented on a combined basis for any periods they are under common control or management. For purposes of this section, businesses shall be deemed to be related if:

(i) They are under common control or management;

(ii) The acquisition of one business is conditional on the acquisition of each other business; or

(iii) Each acquisition is conditioned on a single common event.

(4) This rule shall not apply to a business which is totally held by the registrant prior to consummation of the transaction.

(b) Periods to be presented.

(1) If securities are being registered to be offered to the security holders of the business to be acquired, the financial statements specified in Rules 3-01 and 3-02 shall be furnished for the business to be acquired, except as provided otherwise for filings on Form N-14, S-4, or F-4. The financial statements covering fiscal years shall be audited except as provided in Item 14 of Schedule 14A with respect to certain proxy statements or in registration statements filed on Forms N-14, S-4, or F-4.

(2) In all cases not specified in paragraph (b)(1) of this section, financial statements of the business acquired or to be acquired shall be filed for the periods specified in this paragraph (b)(2) or such shorter period as the business has been in existence. The periods for which such financial statements are to be filed shall be determined using the conditions specified in the definition of significant subsidiary in Rule 1-02(w) as follows:

(i) If none of the conditions exceeds 20 percent, financial statements are not required. However, if the aggregate impact of the individually insignificant businesses acquired since the date of the most recent audited balance sheet filed for the registrant exceeds 50 percent, financial statements covering at least the substantial majority of the businesses acquired shall be furnished. Such financial statements shall be for at least the most recent fiscal year and any interim periods specified in Rules 3-01 and 3-02.

(ii) If any of the conditions exceeds 20 percent, but none exceed 40 percent, financial statements shall be furnished for at least the most recent fiscal year and any interim periods specified in Rules 3-01 and 3-02.

(iii) If any of the conditions exceeds 40 percent, but none exceed 50 percent, financial statements shall be furnished for at least the two most recent fiscal years and any interim periods specified in Rules 3-01 and 3-02.

(iv) If any of the conditions exceeds 50 percent, the full financial statements specified in Rules 3-01 and 3-02 shall be furnished. However, financial statements for the earliest of the three fiscal years required may be omitted if net revenues reported by the acquired business in its most recent fiscal year are less than $50 million.

(3) The determination shall be made by comparing the most recent annual financial statements of each such business, or group of related businesses on a combined basis, to the registrant's most recent annual consolidated financial statements filed at or prior to the date of acquisition. However, if the registrant made a significant acquisition subsequent to the latest fiscal year-end and filed a report on Form 8-K which included audited financial statements of such acquired business for the periods required by this section and the pro forma financial information required by Article 11, such determination may be made by using pro forma amounts for the latest fiscal year in the report on Form 8-K rather than by using the historical amounts of the registrant. The tests may not be made by "annualizing" data.

(4) Financial statements required for the periods specified in paragraph (b)(2) of this section may be omitted to the extent specified as follows:

(i) Registration statements not subject to the provisions of Rule 419 of Regulation C and proxy statements need not include separate financial statements of the acquired or to be acquired business if it does not exceed any of the conditions of significance in the definition of significant subsidiary in Rule 1-02 at the 50 percent level, and either:

(A) The consummation of the acquisition has not yet occurred; or

(B) The date of the final prospectus or prospectus supplement relating to an offering as filed with the Commission pursuant to Rule 424(b) of Regulation C, or mailing date in the case of a proxy statement, is no more than 74 days after consummation of the business combination, and the financial statements have not previously been filed by the registrant.

(ii) An issuer, other than a foreign private issuer required to file reports on Form 6-K, that omits from its initial registration statement financial statements of a recently consummated business combination pursuant to paragraph (b)(4)(i) of this section shall furnish those financial statements and any pro forma information specified by Article 11 of this chapter

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under cover of Form 8-K no later than 75 days after consummation of the acquisition.

(iii) Separate financial statements of the acquired business need not be presented once the operating results of the acquired business have been reflected in the audited consolidated financial statements of the registrant for a complete fiscal year unless such financial statements have not been previously filed or unless the acquired business is of such significance to the registrant that omission of such financial statements would materially impair an investor's ability to understand the historical financial results of the registrant. For example, if, at the date of acquisition, the acquired business met at least one of the conditions in the definition of significant subsidiary in Rule 1-02 at the 80 percent level, the income statements of the acquired business should normally continue to be furnished for such periods prior to the purchase as may be necessary when added to the time for which audited income statements after the purchase are filed to cover the equivalent of the period specified in Rule 3-02.

(iv) A separate audited balance sheet of the acquired business is not required when the registrant's most recent audited balance sheet required by Rule 3-01 is for a date after the date the acquisition was consummated.

(c) Financial statements of foreign businesses.

If the business acquired or to be acquired is a foreign business, financial statements of the business meeting the requirements of Item 17 of Form 20-F will satisfy this section.

Rule 1-02: Definition of Terms Used in Regulation S-X

(w) SIGNIFICANT SUBSIDIARY. The term "significant subsidiary" means a subsidiary, including its subsidiaries, which meets any of the following conditions:

(1) The registrant's and its other subsidiaries' investments in and advances to the subsidiary exceed 10 percent of the total assets of the registrant and its subsidiaries consolidated as of the end of the most recently completed fiscal year (for a proposed business combination between entities under common control, this condition is also met when the number of common shares exchanged or to be exchanged by the registrant exceeds 10 percent of its total common shares outstanding at the date the combination is initiated); or

(2) The registrant's and its other subsidiaries' proportionate share of the total assets (after intercompany eliminations) of the subsidiary exceeds 10 percent of the total assets of the registrant and its subsidiaries consolidated as of the end of the most recently completed fiscal year; or

(3) The registrant's and its other subsidiaries' equity in the income from continuing operations before income taxes, extraordinary items and cumulative effect of a change in

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accounting principle of the subsidiary exclusive of amounts attributable to any noncontrolling interests exceeds 10 percent of such income of the registrant and its subsidiaries consolidated for the most recently completed fiscal year.

COMPUTATIONAL NOTE: For purposes of making the prescribed income test the following guidance should be applied:

NOTE TO PARAGRAPH (w): A registrant that files its financial statements in accordance with or provides a reconciliation to U.S. Generally Accepted Accounting Principles shall make the prescribed tests using amounts determined under U.S. Generally Accepted Accounting Principles. A foreign private issuer that files its financial statements in accordance with IFRS as issued by the IASB shall make the prescribed tests using amounts determined under IFRS as issued by the IASB.

1. When a loss exclusive of amounts attributable to any noncontrolling interests has been incurred by either the parent and its subsidiaries consolidated or the tested subsidiary, but not both, the equity in the income or loss of the tested subsidiary exclusive of amounts attributable to any noncontrolling interests should be excluded from the income of the registrant and its subsidiaries consolidated for purposes of the computation.
2. If income of the registrant and its subsidiaries consolidated exclusive of amounts attributable to any noncontrolling interests for the most recent fiscal year is at least 10 percent lower than the average of the income for the last five fiscal years, such average income should be substituted for purposes of the computation. Any loss years should be omitted for purposes of computing average income.
3. Where the test involves combined entities, as in the case of determining whether summarized financial data should be presented, entities reporting losses shall not be aggregated with entities reporting income.

***Rule 8-04: Financial Statements of Businesses Acquired or to Be Acquired* [Guidance for Smaller Reporting Companies]**

(a) If a business combination has occurred or is probable, financial statements of the business acquired or to be acquired shall be furnished for the periods specified in paragraph (c) of this section:

(1) This encompasses the purchase of an interest in a business accounted for by the equity method.

(2) Acquisitions of a group of related businesses that are probable or that have occurred subsequent to the latest fiscal year end for which audited financial statements of the issuer have been filed shall be treated as if they are a single business

combination for purposes of this section. The required financial statements of related businesses may be presented on a combined basis for any periods they are under common control or management. A group of businesses is deemed to be related if:

(i) They are under common control or management;

(ii) The acquisition of one business is conditioned on the acquisition of each other business; or

(iii) Each acquisition is conditioned on a single common event.

(3) Annual financial statements required by this rule shall be audited. The form and content of the financial statements shall be in accordance with § § 210.8-02 and 8-03.

(b) The periods for which financial statements are to be presented are determined by comparison of the most recent annual financial statements of the business acquired or to be acquired and the smaller reporting company's most recent annual financial statements filed at or before the date of acquisition to evaluate each of the following conditions:

(1) Compare the smaller reporting company's investments in and advances to the acquiree to the total consolidated assets of the smaller reporting company as of the end of the most recently completed fiscal year.

(2) Compare the smaller reporting company's proportionate share of the total assets (after intercompany eliminations) of the acquiree to the total consolidated assets of the smaller reporting company as of the end of the most recently completed fiscal year.

(3) Compare the smaller reporting company's equity in the income from continuing operations before income taxes, extraordinary items and cumulative effect of a change in accounting principles of the acquiree exclusive of amounts attributable to any noncontrolling interests to such consolidated income of the smaller reporting company for the most recently completed fiscal year.

Computational note to § 210.8-04(b): For purposes of making the prescribed income test the following guidance should be applied: If income of the smaller reporting company and its subsidiaries consolidated exclusive of amounts attributable to any noncontrolling interests for the most recent fiscal year is at least 10 percent lower than the average of the income for the last five fiscal years, such average income should be substituted for purposes of the computation. Any loss years should be omitted for purposes of computing average income.

(c) (1) If none of the conditions specified in paragraph (b) of this section exceeds 20%, financial statements are not required. If any of the conditions exceed 20%, but none exceeds 40%, financial statements shall be furnished for the most recent fiscal year and any interim period specified in § 210.8-03. If any of the conditions exceed 40%, financial statements shall be furnished for the two most recent fiscal years and any interim periods specified in § 210.8-03.

(2) The separate audited balance sheet of the acquired business is not required when the smaller reporting company's most recent audited balance sheet filed is for a date after the acquisition was consummated.

(3) If the aggregate impact of individually insignificant businesses acquired since the date of the most recent audited balance sheet filed for the registrant exceeds 50%, financial statements covering at least the substantial majority of the businesses acquired shall be furnished. Such financial statements shall be for the most recent fiscal year and any interim periods specified in § 210.8-03.

(4) Registration statements not subject to the provisions of § 230.419 of this chapter (Regulation C) and proxy statements need not include separate financial statements of the acquired or to be acquired business if it does not meet or exceed any of the conditions specified in paragraph (b) of this section at the 50 percent level, and either:

(i) The consummation of the acquisition has not yet occurred; or

(ii) The effective date of the registration statement, or mailing date in the case of a proxy statement, is no more than 74 days after consummation of the business combination, and the financial statements have not been filed previously by the registrant.

(5) An issuer that omits from its initial registration statement financial statements of a recently consummated business combination pursuant to paragraph (c)(4) of this section shall furnish those financial statements and any pro forma information specified by § 210.8-05 under cover of Form 8-8K (§ 249.308 of this chapter) no later than 75 days after consummation of the acquisition.

(d) If the smaller reporting company made a significant business acquisitions after the latest fiscal year end and filed a report on Form 8-K, which included audited financial statements of such acquired business for the periods required by paragraph (c) of this section and the pro forma financial information required by § 210.8-05, the determination of significance may be made by using pro forma amounts for the latest fiscal year in the report on Form 8-K rather than by using the historical amounts of the registrant. The tests may not be made by "annualizing" data.

(e) If the business acquired or to be acquired is a foreign business, financial statements of the business meeting the requirements of Item 17 of Form 20-F (§ 249.220f of this chapter) will satisfy this section.

Rule 8-05: Pro Forma Financial Information **[Guidance for Smaller Reporting Companies]**

(a) Pro forma information showing the effects of the acquisition shall be furnished if financial statements of a business acquired or to be acquired are presented.

(b) Pro forma statements should be condensed, in columnar form showing pro forma adjustments and results, and should include the following:

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(1) If the transaction was consummated during the most recent fiscal year or subsequent interim period, pro forma statements of income reflecting the combined operations of the entities for the latest fiscal year and interim period, if any; or

(2) If consummation of the transaction has occurred or is probable after the date of the most recent balance sheet required by § 210.8-02 or § 210.8-03, a pro forma balance sheet giving effect to the combination as of the date of the most recent balance sheet. For a purchase, pro forma statements of income reflecting the combined operations of the entities for the latest fiscal year and interim period, if any, are required.

Rule 11-01: Pro Forma Financial Information Presentation Requirements

(a) Pro forma financial information shall be furnished when any of the following conditions exist:

(1) During the most recent fiscal year or subsequent interim period for which a balance sheet is required by Rule 3-01, a significant business combination has occurred (for purposes of these rules, this encompasses the acquisition of an interest in a business accounted for by the equity method);

(2) After the date of the most recent balance sheet filed pursuant to Rule 3-01, consummation of a significant business combination or a combination of entities under common control has occurred or is probable;

(3) Securities being registered by the registrant are to be offered to the security holders of a significant business to be acquired or the proceeds from the offered securities will be applied directly or indirectly to the purchase of a specific significant business;

(4) The disposition of a significant portion of a business either by sale, abandonment or distribution to shareholders by means of a spin-off, split-up or split-off has occurred or is probable and such disposition is not fully reflected in the financial statements of the registrant included in the filing;

(5) During the most recent fiscal year or subsequent interim period for which a balance sheet is required by Rule 3-01, the registrant has acquired one or more real estate operations or properties which in the aggregate are significant, or since the date of the most recent balance sheet filed pursuant to that section the registrant has acquired or proposes to acquire one or more operations or properties which in the aggregate are significant.

(6) Pro forma information required by Rule 914 of Regulation S-K is required to be provided in connection with a roll-up transaction as defined in Rule 901 (c) of Regulation S-K.

(7) The registrant previously was a part of another entity and such presentation is necessary to reflect operations and financial position of the registrant as an autonomous entity; or

(8) Consummation of other events or transactions has occurred or is probable for which disclosure of pro forma financial information would be material to investors.

(b) A business combination or disposition of a business shall be considered significant if:

(1) A comparison of the most recent annual financial statements of the business acquired or to be acquired and the registrant's most recent annual consolidated financial statements filed at or prior to the date of acquisition indicates that the business would be a significant subsidiary pursuant to the conditions specified in Rule 1-02(w), substituting 20 percent for 10 percent each place it appears therein; or

(2) The business to be disposed of meets the conditions of a significant subsidiary in Rule 1-02(w).

(c) The pro forma effects of a business combination need not be presented pursuant to this section if separate financial statements of the acquired business are not included in the filing.

(d) For purposes of this rule, the term business should be evaluated in light of the facts and circumstances involved and whether there is sufficient continuity of the acquired entity's operations prior to and after the transactions so that disclosure of prior financial information is material to an understanding of future operations. A presumption exists that a separate entity, a subsidiary, or a division is a business. However, a lesser component of an entity may also constitute a business. Among the facts and circumstances which should be considered in evaluating whether an acquisition of a lesser component of an entity constitutes a business are the following:

(1) Whether the nature of the revenue-producing activity of the component will remain generally the same as before the transaction; or

(2) Whether any of the following attributes remain with the component after the transaction:

(i) Physical facilities,

(ii) Employee base,

(iii) Market distribution system,

(iv) Sales force,

(v) Customer base,

(vi) Operating rights,

(vii) Production techniques, or

(viii) Trade names.

(e) This rule does not apply to transactions between a parent company and its totally held subsidiary.

SAB Topic 1J: Application of Rule 3-05 in Initial Public Offerings

Facts: Rule 3-05 of Regulation S-X establishes the financial statement requirements for businesses acquired or to be acquired. If required, financial statements must be provided for one, two, or three years depending upon the relative

significance of the acquired entity as determined by the application of Rule 1-02(w) of Regulation S-X. The calculations required for these tests are applied by comparison of the financial data of the registrant and acquiree(s) for the fiscal years most recently completed prior to the acquisition. The staff has recognized that these tests literally applied in some initial public offerings may require financial statements for an acquired entity which may not be significant to investors, because the registrant has had substantial growth in assets and earnings in recent years.[1]

Question: How should Rules 3-05 and 1-02(w) of Regulation S-X be applied in determining the periods for which financial statements of acquirees are required to be included in registration statements for initial public offerings?

Interpretive Response: It is the staff's view that initial public offerings involving businesses that have been built by the aggregation of discrete businesses that remain substantially intact after acquisition[2] were not contemplated during the drafting of Rule 3-05 and that the significance of an acquired entity in such situations may be better measured in relation to the size of the registrant at the time the registration statement is filed, rather than its size at the time the acquisition was made. Therefore, for a first time registrant, the staff has indicated that in applying the significance tests in Rule 3-05, the three tests in Rule 1-02(w) generally can be measured against the combined entities, including those to be acquired, which comprise the registrant at the time the registration statement is filed. The staff's policy is intended to ensure that the registration statement will include not less than three, two and one year(s) of audited financial statements for not less than 60 percent, 80 percent, and 90 percent, respectively, of the constituent businesses that will comprise the registrant on an ongoing basis. In all circumstances, the audited financial statements of the registrant are required for three years, or since its inception, if less than three years. The requirement to provide the audited financial statements of a constituent business in the registration statement is satisfied for the postacquisition period by including the entity's results in the audited consolidated financial statements of the registrant. If additional periods are required, the entity's separate audited financial statements for the immediate preacquisition period(s) should be presented.[3]

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In order for the preacquisition audited financial statements of an acquiree to be omitted from the registration statement, the following conditions must be met:

a. The combined significance of businesses acquired or to be acquired for which audited financial statements cover a period of less than nine months[4] may not exceed 10 percent;

[1] An acquisition which was relatively significant in the earliest year for which a registrant is required to file financial statements may be insignificant to its latest fiscal year due to internal growth and/or subsequent acquisitions. Literally applied, Rules 3-05 and 1-02(w) might still require separate financial statements for the now insignificant acquisition.

[2] For example, nursing homes, hospital or cable TV systems. This interpretation would not apply to businesses for which the relative significance of one portion of the business to the total business may be altered by postacquisition decisions as to the allocation of incoming orders between plants or locations. This bulletin does not address all possible cases in which similar relief may be appropriate but, rather, attempts to describe a general framework within which administrative policy has been established. In other distinguishable situations, registrants may request relief as appropriate to their individual facts and circumstances.

[3] If audited preacquisition financial statements of a business are necessary pursuant to the alternative tests described here, the interim period following that entity's latest preacquisition fiscal year-end, but prior to its acquisition by the registrant, generally would be required to be audited.

[4] As a matter of policy the staff accepts financial statements for periods of not less than 9, 21, and 33 consecutive months (not more than 12 months may

b. The combined significance of businesses acquired or to be acquired for which audited financial statements cover a period of less than 21 months may not exceed 20 percent; and

c. The combined significance of businesses acquired or to be acquired for which audited financial statements cover a period of less than 33 months may not exceed 40 percent.

Combined significance is the total, for all included companies, of each individual company's highest level of significance computed under the three tests of significance. The significance tests should be applied to proforma financial statements of the registrant, prepared in a manner consistent with Article 11 of Regulation S-X. The pro forma balance sheet should be as of the date of the registrant's latest balance sheet included in the registration statement, and should give effect to businesses acquired subsequent to the end of the latest year or to be acquired as if they had been acquired on that date. The pro forma statement of operations should be for the registrant's most recent fiscal year included in the registration statement and should give effect to all acquisitions consummated during and subsequent to the end of the year and probable acquisitions as if they had been consummated at the beginning of that fiscal year.

The three tests specified in Rule 1-02(w) should be made in comparison to the registrant's pro forma consolidated assets and pretax income from continuing operations. The assets and pretax income of the acquired businesses which are being evaluated for significance should reflect any new cost basis arising from purchase accounting.

EXAMPLE: On February 20, 20X9, Registrant files Form S-1 containing its audited consolidated financial statements as of and for the three years ended December 31, 20X8. Acquisitions since inception have been:

Acquiree	Fiscal Year-End	Date of Acquisition	Highest Significance at Acquisition (Percent)
A	3/31	1/1/X7	60%
B	7/31	4/1/X7	45%
C	9/30	9/1/X7	40%
D	12/31	2/1/X8	21%
E	3/31	11/1/X8	11%
F	12/31	to be acquired	11%

The following table reflects the application of the significance tests to the combined financial information at the time the registration statement is filed.

	Significance of			
Component Entity	Assets	Earnings	Investment	Highest Level of Significance
A	12%	23%	12%	23%
B	10%	21%	10%	21%
C	21%	3%	4%	21%
D	10%	5%	13%	13%

(Footnote Continued)

be included in any period reported on) as substantial compliance with requirements for financial statements for 1, 2, and 3 years, respectively.

Component Entity	Significance of Assets	Earnings		Investment	Highest Level of Significance
E	4%	9%	loss	3%	9%
F	2%	11%		6%	11%

Year 1 (most recent fiscal year)—Entity E is the only acquiree for which preacquisition financial statements may be omitted for the latest year, since significance for each other entity exceeds 10% under one or more test.

Year 2 (preceding fiscal year)—Financial statements for E and F may be omitted since their combined significance is 20% and no other combination can be formed with E which would not exceed 20%.

Year 3 (second preceding fiscal year)—Financial statements for D, E, and F may be omitted since the combined significance of these entities is 33%[5] and no other combination can be formed with E and F which would not exceed 40%.

The financial statement requirements must be satisfied by filing separate preacquisition audited financial statements for each entity that was not included in the consolidated financial statements for the periods set forth above. The following table illustrates the requirements for this example.

Component Entity	Date of Acquisition	Minimum Financial Statement Requirement	Period in Consolidated F/S (months)	Separate Preacquisition Audited F/S
Registrant	N/A	33	36	
A	1/1/X7	33	24	9
B	4/1/X7	33	21	12[6]
C	9/1/X7	33	16	17
D	2/1/X8	21	11	10
E	11/1/X8	—	2	—
F	to be acquired	9	—	9

[6] The audited preacquisition period need not correspond to the acquiree's preacquisition fiscal year. However, audited periods must not be for periods in excess of 12 months.

Division of Corporation Finance, Financial Reporting Manual, Sections 1170, 2005.4, and 2015

1170.1 What Is a Predecessor Entity

The definition of "predecessor" in Regulation C, Rule 405 is very broad. For purposes of financial statements, designation of an acquired business as a predecessor is generally not required except where a registrant succeeds to substantially all of the business (or a separately identifiable line of business) of another entity (or group of entities) and the registrant's own operations before the succession appear insignificant relative to the operations assumed or acquired.

[5] Combined significance is the sum of the significance of D's investment test (13%), E's earnings test (9%) and F's earnings test (11%).

1170.2 Financial Statement Dates and Periods

Financial information of a registrant's predecessor is required for all periods prior to the succession, with no lapse in audited periods or omission of other information required about the registrant. Financial statements for the registrant and its predecessor should collectively be 'as of' all dates and 'for' all periods required by S-X Articles 3 and 10 (or Article 8 for SRC). Any interim period of the predecessor before its acquisition by the registrant should be audited when audited financial statements for the period after the acquisition are presented. Schedules required by S-X Article 12 are required for predecessor entities.

a. After an acquisition, financial statements of the predecessor should be included in Forms 10-K and 10-Q for the required comparative periods before the acquisition, in addition to those of the registrant.

b. After a reverse acquisition or recapitalization, or the acquisition of a business by a special purpose acquisition company (SPAC), the financial statements of the registrant for periods prior to the acquisition may not be required to be included in Forms 10-K and 10-Q once the financial statements include the period in which the acquisition or recapitalization was consummated. Generally, these financial statements would not be required in cases in which the registrant had only nominal income statement activity. *(Last updated 6/30/2010)*

c. S-X 3-01 and 8-02 do not specifically refer to balance sheets of predecessors. When only one registrant balance sheet would otherwise be included in the filing, a registrant, including a Smaller Reporting Company, must file an audited predecessor balance sheet as of the end of its last fiscal year. *(Last updated 6/30/2010)*

1170.3 Partial Year Financial Statements

When predecessor audited financial statements are provided for part of a fiscal year and successor audited financial statements are provided for the rest of the year, the predecessor is not required to provide comparative financial statements for the prior year partial period.

EXAMPLE: A shell company formed on January 15, 2009 acquires an operating company, determined to be its predecessor, on June 25, 2009. The Newco subsequently files an IPO registration statement in the third quarter of 2010. The IPO registration statement must include audited financial statements of the predecessor for the two years ended December 31, 2008 and the period from January 1, 2009 to June 25, 2009. The Newco registrant must provide audited financial statements for the period from the inception date through December 31, 2009 (there were no operations from inception date to acquisition date) and unaudited interim financial statements for the periods ending June 30, 2009 and June 30, 2010. Financial statements of the predecessor for the period January 1, 2008 to June 25, 2008 are not required.

2005.4 "Probable"

Assessment of "probability" requires consideration of all available facts. Acquisition is probable where registrant's financial statements alone would not provide adequate financial information to make an investment decision. [FRC 506.02(c)(ii)]

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2015 Measuring Significance—Basics [S-X 3-05(b)(2)]

Note to Section 2015: Registrants may request CF-OCA interpretation in unusual situations or relief where strict application of the rules and guidelines results in a requirement that is unreasonable under the circumstances.

2015.1 Registrants must measure the significance of an acquired business under S-X 3-05 and S-X 8-04 using three tests, the:

- Asset test,
- Investment test, and
- Income test.

These tests are described in further detail below.

Note to Section 2015.1: In certain circumstances, registrants preparing an initial registration statement may consider applying SAB 80 instead of S-X 3-05 or S-X 8-04. See further discussion at Section 2070, "SAB 80: Application of S-X 3-05 in Initial Registration Statements (SAB Topic 1J)."

2015.2 Financial Statements Used to Measure Significance

Generally, compare the most recent pre-acquisition annual financial statements of the acquired business to the registrant's pre-acquisition consolidated financial statements as of the end of the most recently completed audited fiscal year required to be filed with the SEC. Financial statements of both the acquired business and the registrant used to measure significance must be prepared in accordance with the comprehensive basis of accounting described in Section 2015.3, "Comprehensive Basis of Accounting Used to Measure Significance."

If a change in the reporting entity or a reorganization will occur at or after effectiveness of an initial registration statement but no later than closing of the IPO, the staff will consider requests for relief to use the combined financial statement amounts as the denominator for purposes of significance calculations in determining other financial statement requirements for the filing (e.g., S-X 3-05 and 3-09). *(Last updated: 3/31/2010)*

2015.3 Comprehensive Basis of Accounting Used to Measure Significance

A registrant that files its financial statements in accordance with or is required to provide reconciliation to U.S. GAAP should determine significance using amounts for both the acquired business and the registrant determined in accordance with U.S.GAAP; that is, both the numerator and denominator of the significance test would be determined in accordance with U.S. GAAP. A foreign private issuer that files its financial statements in accordance with IFRS as issued by the IASB should determine significance using amounts for both the acquired business and the registrant determined in accordance with IFRS as issued by the IASB; that is both the numerator and denominator of the significance test would be determined in accordance with IFRS as issued by the IASB. To illustrate these requirements, if a registrant that files its financial statements in accordance with U.S. GAAP acquires, both legally and for accounting purposes, a foreign private issuer or a foreign business that files its financial statements in accordance with IFRS as issued by the IASB, significance (both the numerator and denominator) must be determined in accordance with U.S. GAAP. This is true even though the acquired business did not reconcile its financial statements to U.S. GAAP.

2015.4 Asset Test

Compare registrant's share of acquired business's total assets to the registrant's consolidated total assets. **Ordinary receivables and other working capital amounts** not acquired should nevertheless be included as part of the assets of the acquired enterprise in tests of significance relative to the registrant's assets because that working capital is expected to be required and funded after the acquisition.

2015.5 Investment Test—Acquisition Accounting under SFAS 141R [ASC 805] and IFRS 3 (Revised 2008) as issued by the IASB

Compare the total GAAP purchase price of the acquired business, as adjusted below, to the registrant's consolidated total assets.

GAAP purchase price in this context means the "consideration transferred," as that term is used in the applicable accounting standard. Thus, the investment test computed for an acquisition accounted for under SFAS 141R [ASC 805] and IFRS 3 (Revised 2008) as issued by the IASB will differ from the investment test computed for an acquisition accounted for under SFAS 141 and IFRS 3 (prior to the 2008 revision) as issued by the IASB in part because it will include the acquisition-date fair value of all contingent consideration and exclude acquisition-related costs.

The adjustment—For purposes of the "investment" test, "consideration transferred" should be adjusted to exclude carrying value of assets transferred by the acquirer to the acquired business that will remain with the combined entity after the business combination.

Note to Section 2015.5: The numerator of the investment test for the purchase of an equity method investment should include transaction costs, consistent with the accounting under ASC 323-10. The numerator should also include contingent consideration (on a gross basis) if the likelihood of payment is more than remote. *(Last updated: 3/31/2010)*

2015.6 Investment Test—Purchase Accounting under SFAS 141 and IFRS 3 (prior to the 2008 revision) as issued by the IASB

Compare total GAAP purchase price of acquired business, as adjusted below, to registrant's consolidated total assets. *GAAP purchase price* in this context means the "cost of the acquired entity", as that phrase is used in SFAS 141, or "cost of the business combination" as that term is used in IFRS 3 (prior to the 2008 revision). For purposes of the "investment" test, "cost of the acquired entity" or "cost of a business combination" should be adjusted to:

- Include the liabilities incurred by the acquirer to the former owners of the acquiree, but exclude pre-acquisition debt and other liabilities of the acquired business assumed in the business combination and
- Include any contingent consideration that represents additional purchase price as part of the total investment in the acquiree unless the likelihood of its payment is remote.

Notes to Section 2015.6:

(1) IFRS 3 (prior to the 2008 revision) states in part that the cost of a business combination is the aggregate of the fair values of assets given, liabilities incurred or assumed, and equity instruments issued by the acquirer. As noted above, liabilities incurred to the former owners of the acquiree are included in the investment test, but pre-acquisition

liabilities of the acquired business that are assumed in the business combination are excluded from the investment test.

(2) Generally, contingencies based on security prices do not change the recorded cost of the acquired company under SFAS 141 or the cost of the business combination under IFRS 3 (prior to the 2008 revision) and therefore should be excluded from the investment test. Generally, contingent consideration based on earnings will either be included as part of the cost of the acquired company or compensation. If it is part of the cost of the acquired company, it should be included in the investment test unless the likelihood of payment is remote. If it is compensation, it may be excluded from the investment test.

(3) For U.S. GAAP, see SFAS 141, paragraphs 25-27 for a discussion of the accounting for contingent consideration and EITF 95-8 for determining whether consideration contingent on earnings is part of the cost of an acquired entity or whether it represents compensation.

(4) For IFRS as issued by the IASB, see IFRS 3 (prior to the 2008 revision), paragraphs 32-35 for a discussion of the accounting for contingent consideration.

2015.7 Investment Test—Reorganization of Entities Under Common Control

Compare the net book value of the acquired business to the registrant's consolidated assets and compare the number of shares exchanged to registrant's outstanding shares at the date the combination is initiated.

2015.8 Income Test

Compare registrant's equity in the acquired business's income from continuing operations before taxes, extraordinary items and cumulative effect of a change in accounting principle to that of the registrant.

There are three computational notes to the income test included at S-X 1-02(w). The second computational note indicates that if the registrant's income for the most recent fiscal year is 10% or more lower than the average of the registrant's income for the last five fiscal years, then the average income of the registrant should be used for this computation. This computational note also applies if the registrant reported a loss, rather than income. If the registrant reported a loss, the registrant should compare the absolute value of its reported loss to its average income for the last five fiscal years to determine if the registrant is required to use average income. In computing the registrant's average income for the last five fiscal years, loss years should be assigned a value of zero in computing the numerator for this average, but the denominator should be "5". Also, the acquiree's income may not be averaged. *(Last updated: 12/31/2010)*

2015.9 Significance—Absolute Values

In the case of a single acquisition, if either the registrant or the acquired business reported a pretax loss and the other entity reported pretax income, use the absolute values.

2015.10 Significance—Denominator

The acquired business is not considered part of the registrant's denominator in determining significance for purposes of S-X 3-05 [S-X 1-02(w)].

2015.11 Significance—Intercompany Transactions

When measuring significance for all three S-X 1-02(w) tests, intercompany transactions between the registrant and acquiree should be eliminated in the same way that would occur if the acquiree were consolidated. See by analogy S-X 1-02(w)(2). *(Last updated: 9/30/2009)*

2015.12 Significance— "Related Businesses"

Acquisitions of "related businesses"" must be treated as a single business acquisition. Businesses are related under S-X 3-05 if:

- They are under common control or management, or
- Their acquisitions are dependent on each other or a single common event or condition

2015.13 Significance—Rounding

Do not round the results of the significance tests.

Division of Corporation Finance, Financial Reporting Manual, Section 2020.5

2020.5 Significance Implementation—Acquiring an Additional Interest in a Consolidated Entity

When a registrant increases its investment in a company that is already reflected as a consolidated subsidiary in the audited financial statements of the registrant for a complete fiscal year, financial statements of the acquired investment are *ordinarily* not required. However, pro forma information may be required.

The staff's view that financial statements are ordinarily not required is premised on S-X 3-05(b)(4)(iii) which states that separate financial statements of the acquired business need not be presented once the operating results of the acquired business have been reflected in the audited consolidated financial statements of the registrant for a complete fiscal year unless such financial statements have not been previously filed or unless the acquired business is of major significance. Illustrative, but not all-inclusive, examples of when historical financial statements of an acquired business may be required in a step acquisition include:

- acquired business financial statements have not been previously filed for the entire period for which historical financial statements of the acquired entity would be required under S-X 3-05;
- acquired business is of major significance; or
- S-X 3-05 does not apply; such as a proxy statement or Form S-4 requirement to present the target's financial statements for the same periods that would be required in an annual report sent to security holders, if an annual report was required.

Also, note that while S-X 11-01(c) states that pro forma effects of a business combination need not be presented if the acquired business' financial statements are not presented, we believe such pro forma financial statements are required pursuant to S-X 11-01(a)(8) when pro forma financial information giving effect to the step acquisition would be material to investors.

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Division of Corporation Finance, Financial Reporting Manual, Section 2020.8

2020.8 Significance Implementation—Related Businesses—General

S-X 3-05 requires that related businesses be treated as a single business when measuring significance. Further guidance on this requirement is included below. If S-X 3-05 significance is met, separate financial statements of each of the related businesses are required, except that financial statements of the related businesses that are under common control or management may be, but are not required to be, presented on a combined basis for any annual or interim periods specified in S-X 3-05 for which the businesses are under common control or management. If the registrant believes that application of the significance tests results in a requirement to present financial statements of one or more related businesses that are not reasonably necessary to inform investors, the registrant may make a request to CF-OCA for relief.

NOTES to SECTION 2020.8

1. If related businesses have different fiscal year ends, a registrant should not conform the fiscal year-ends of the related businesses for purposes of the significance tests.
2. The reference to "periods specified in S-X 3-05" is meant to clarify that in order to present financial statements of related businesses on a combined basis for an annual or interim period specified in S-X 3-05, the related businesses must be under common control or management for the entirety of that annual or interim period.
3. S-X 3-05(a)(3) states in part "Acquisitions of a group of related businesses that are probable or that have occurred subsequent to the latest fiscal year-end for which audited financial statements of the registrant have been filed **shall be treated under this section** [emphasis added] as if they are a single business combination." The staff interprets this requirement to mean that S-X 1-02(w) Computational Note 3, which indicates that entities reporting losses should not be aggregated with entities reporting income, does not apply to the calculation of significance for related businesses.

Question	Yes	No	Disclosure Requirement Met?	Reference
2. Is the company preparing an initial public offering (IPO) involving businesses that have been built by the aggregation of discrete businesses that remain substantially intact after acquisition?	____	____	____	____

Disclosure Requirements

In some cases involving initial public offerings, strict application of the requirements of Rule 3-05 would be problematic or would result in the presentation of financial statements that are clearly not material. In these cases, registrants should consider whether electing to apply the alternative requirements of SAB Topic 1J could provide relief from the requirements resulting from the application of Rule 3-05. SAB Topic 1J uses the pro forma financial information for the registrant as a base to measure significance and then requires "coverage" (via audited historical financial statements of acquired businesses) of a stated percentage of the registrant's business for each of the last three years. SAB Topic 1J is a completely separate and alternative approach to measuring significance. It is advisable to identify the financial statement requirements under both SAB Topic 1J and Rule 3-05 to determine the best alternative to follow for a particular registrant's circumstance.

References: Regulation S-X, Rule 3-05 (see above); SAB Topic 1J (see above)

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Question	Yes	No	Disclosure Requirement Met?	Reference
3. Did the company acquire a significant business, acquire a series of individually insignificant businesses that are significant in the aggregate, or dispose of a significant portion of a business?	____	____	________	____

Disclosure Requirements

Provide pro forma information for significant acquisitions or disposals that ha occurred during the current period or as a subsequent event (prior to th issuance of the financial statements) or are otherwise probable of occurrin Significance of a business combination for determining the requirements t provide pro forma information is defined in SEC Rule 11-01. (For acquisitions o troubled financial institutions, see SAB Topic 1K.) Provide:

1. Pro forma condensed income statements for the most recent fiscal ye and any interim period;
2. Pro forma condensed balance sheet as of the end of the latest inter period; and
3. Accompanying explanatory notes to the pro forma financial statem

The Financial Reporting Manual provides that if contingent consideration i issuable (see ASC 805-30-20), the registrant should disclose the terms of th contingent consideration and the potential impact on future earnings. Conting consideration classified as an asset or liability should be remeasured to fair val at each reporting date until the contingency is resolved, and these changes in fa value are generally recognized in earnings.

If updated pro forma income statements are filed with a new or amende registration statement, these statements should not reflect any pro forma adjus ments to give effect to changes in the fair value of contingent consideration i periods different than those in which such changes were recognized in th acquirer's postacquisition financial statements. Pro forma financial informati should include transparent disclosure about the contingent consideration a rangement and known changes in fair value.

At the June 18, 2013, SEC Regulations Committee Meeting, the SEC staff di cussed specific factors that a smaller reporting company should consider i deciding whether to provide pro forma information reflecting a significa disposition of a business. The SEC staff indicated that the nature and extent o pro forma information to be provided by a smaller reporting company to reflect significant disposition of a business requires judgment based on all relevant fa and circumstances. The SEC staff indicated that an acceptable approach would b for smaller reporting companies to look at guidance in S-X Rule 11-01 for larg reporting companies and exercise judgment as to whether the significa thresholds applicable for the larger companies are appropriate to the smal

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reporting company. This is consistent with guidance in Section 5320 of the Financial Reporting Manual. However, the SEC staff cautioned that significance prescribed by S-X Rule 11-01 applicable to larger companies may not necessarily be relevant for every smaller reporting company and judgment should be exercised in determining what would be considered material to investors.

During the March 21, 2014, CAQ SEC Regulations Committee meeting, the SEC staff indicated that when pro forma income statements are provided in a filing for all periods presented by the registrant, pro forma income statements would only be required for the annual periods and subsequent interim period. A registrant may, but is not required to, provide a pro forma income statement for the comparative interim period.

References: Regulation S-X, Rules 11-01 (see above) and 11-02; ASC 350 and 805 (not reproduced): Division of Corporation Finance, Financial Reporting Manual, Section 3250; SEC Regulations Committee Meeting Minutes – June 18, 2013 (not reproduced); SEC Regulations Committee Meeting Minutes – March 21, 2014 (not reproduced)

Regulation S-X, Rule 11-02; Division of Corporation Finance, Financial Reporting Manual, Section 3250

Rule 11-02: Preparation Requirements

(a) OBJECTIVE.

Pro forma financial information should provide investors with information about the continuing impact of a particular transaction by showing how it might have affected historical financial statements if the transaction had been consummated at an earlier time. Such statements should assist investors in analyzing the future prospects of the registrant because they illustrate the possible scope of the change in the registrant's historical financial position and results of operations caused by the transaction.

(b) FORM AND CONTENT.

(1) Pro forma financial information shall consist of a pro forma condensed balance sheet, pro forma condensed statements of income, and accompanying explanatory notes. In certain circumstances (i.e., where a limited number of pro forma adjustments are required and those adjustments are easily understood), a narrative description of the pro forma effects of the transaction may be furnished in lieu of the statements described herein.

(2) The pro forma financial information shall be accompanied by an introductory paragraph which briefly sets forth a description of (i) the transaction, (ii) the entities involved and (iii) the periods for which the pro forma information is presented. In addition, an explanation of what the pro forma presentation shows shall be set forth.

(3) The pro forma condensed financial information need only include major captions (i.e., the numbered captions) prescribed by the applicable sections of this Regulation. Where any major balance sheet caption is less than 10 percent of total assets, the caption may be combined with others. When any major income statements caption is

less than 15 percent of average net income attributable to the registrant for the most recent three fiscal years, the caption may be combined with others. In calculating average net income attributable to the registrant, loss years should be excluded unless losses were incurred in each of the most recent three years, in which case the average loss shall be used for purposes of this test. Notwithstanding these tests, de minimis amounts need not be shown separately.

(4) Pro forma statements shall ordinarily be in columnar form showing condensed historical statements, pro forma adjustments, and the pro forma results.

(5) The pro forma condensed income statement shall disclose income (loss) from continuing operations before nonrecurring charges or credits directly attributable to the transaction. Material nonrecurring charges or credits and related tax effects which result directly from the transaction and which will be included in the income of the registrant within the 12 months succeeding the transaction shall be disclosed separately. It should be clearly indicated that such charges or credits were not considered in the pro forma condensed income statement. If the transaction for which pro forma financial information is presented relates to the disposition of a business, the pro forma results should give effect to the disposition and be presented under an appropriate caption.

(6) Pro forma adjustments related to the pro forma condensed income statement shall be computed assuming the transaction was consummated at the beginning of the fiscal year presented and shall include adjustments which give effect to events that are (i) directly attributable to the transaction, (ii) expected to have a continuing impact on the registrant, and (iii) factually supportable. Pro forma adjustments related to the pro forma condensed balance sheet shall be computed assuming the transaction was consummated at the end of the most recent period for which a balance sheet is required by Rule 3-01 and shall include adjustments which give effect to events that are directly attributable to the transaction and factually supportable regardless of whether they have a continuing impact or are nonrecurring. All adjustments should be referenced to notes which clearly explain the assumptions involved.

(7) Historical primary and fully diluted per share data based on continuing operations (or net income if the registrant does not report either discontinued operations, extraordinary items, or the cumulative effects of accounting changes) for the registrant, and primary and fully diluted pro forma per share data based on continuing operations before nonrecurring charges or credits directly attributable to the transaction shall be presented on the face of the pro forma condensed income statement together with the number of shares used to compute such per share data. For transactions involving the issuance of securities, the number of shares used in the calculation of the pro forma per share data should be based on the weighted average number of shares outstanding during the period adjusted to give effect to shares subsequently issued or assumed to be issued had the particular transaction or event taken place at the beginning of the period presented. If a convertible security is being issued in the transaction,

consideration should be given to the possible dilution of the pro forma per share data.

(8) If the transaction is structured in such a manner that significantly different results may occur, additional pro forma presentations shall be made which give effect to the range of possible results.

INSTRUCTIONS.

1. The historical statement of income used in the pro forma financial information shall not report operations of a segment that has been discontinued, extraordinary items, or the cumulative effects of accounting changes. If the historical statements of income includes such items, only the portion of the income statement through "income from continuing operations" (or the appropriate modification thereof) should be used in preparing pro forma results.

2. For a business combination, pro forma adjustments for the income statement shall include amortization, depreciation and other adjustments based on the allocated purchase price of net assets acquired. In some transactions, such as in financial institution acquisitions, the purchase adjustments may include significant discounts of the historical cost of the acquired assets to their fair value at the acquisition date. When such adjustments will result in a significant effect on earnings (losses) in periods immediately subsequent to the acquisition which will be progressively eliminated over a relatively short period, the effect of the purchase adjustments on reported results of operations for each of the next five years should be disclosed in a note.

3. For a disposition transaction, the pro forma financial information shall begin with the historical financial statements of the existing entity and show the deletion of the business to be divested along with the pro forma adjustments necessary to arrive at the remainder of the existing entity. For example, pro forma adjustments would include adjustments of interest expense arising from revised debt structures and expenses which will be or have been incurred on behalf of the business to be divested such as advertising costs, executive salaries and other costs.

4. For entities which were previously a component of another entity, proforma adjustments should include adjustments similar in nature to those referred to in Instruction 3 above. Adjustments may also be necessary when charges for corporate overhead, interest, or income taxes have been allocated to the entity on a basis other than one deemed reasonable by management.

5. Adjustments to reflect the acquisition of real estate operations or properties for the pro forma income statement shall include a depreciation charge based on the new accounting basis for the assets, interest financing on any additional or refinanced debt, and other appropriate adjustments that can be factually supported. See also Instruction 4 above.

6. When consummation of more than one transaction has occurred or is probable during a fiscal year, the pro forma financial information may be presented on a combined basis; however, in some circumstances (e.g., depending upon the combination of probable and consummated transactions, and the nature of the filing) it may be more useful to

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