92-26

CURRENT ACCOUNTING ISSUES AND RELATED DEVELOPMENTS AFFECTING THE DIVISION OF CORPORATION FINANCE
(as of May 2, 1992)

Robert A. Bayless
U.S. Securities & Exchange Commission *
Washington, D.C.

Delivered to the
SEC and Financial Reporting Institute
at the University of Southern California
May 21, 1992

---

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

CURRENT ACCOUNTING ISSUES AND RELATED DEVELOPMENTS
AFFECTING THE DIVISION OF CORPORATION FINANCE
(as of May 2, 1992)

CURRENT ACCOUNTING ISSUES AND RELATED DEVELOPMENTS
AFFECTING THE DIVISION OF CORPORATION FINANCE
(as of May 2, 1992)

I. Recently Adopted Rules and Interpretive Releases

A. Multijurisdictional Disclosure System - Canada

On May 30, 1991, the Commission voted to adopt a multijurisdictional disclosure system ("MJDS") for Canadian issuers. (Rel. No. 33-6902). A Canadian MJDS for U.S. issuers, largely parallel in scope to the MJDS adopted by the Commission, is being implemented through National Policy Statement No. 45 in conjunction with blanket orders and rulings by the securities regulatory authority of each Canadian province and territory. Both the U.S. and the Canadian initiatives are effective as of July 1, 1991.

The MJDS was developed with Canada due to its mature capital markets and strong regulatory tradition. While specific disclosure requirements of the United States and Canada differ in detail, the regulatory systems share the common purpose of ensuring that investors are given information adequate to make an informed investment decision. Key to any effective disclosure system is the application of accounting and auditing standards, and the Commission staff has determined through extensive analysis that Canada, like the United States, has highly developed accounting and auditing standards. Also of particular significance is the extensive cooperation in enforcement matters provided by the 1988 Memorandum of Understanding with British Columbia, Ontario and Quebec, which covers virtually the entire spectrum of cases which could arise under the federal securities laws, and provides for a full range of assistance.

The MJDS adopted by the Commission allows eligible Canadian issuers to register securities under the Securities Act and to register securities and report under the Exchange Act by use of documents prepared largely in accordance with Canadian requirements. In addition, compliance with Canadian tender offer regulation and trust indenture rules in certain cases will suffice for compliance with Commission Williams Act and Trust Indenture Act requirements. The MJDS is available to Canadian foreign private issuers that have been reporting to the Canadian regulatory authority for at least 36 months preceding the filing of the MJDS form. Additional requirements, depending on the particular form used, may involve listing on an

exchange, amounts of public float and market value of equity, and extent of U.S. ownership. Even though Canadian disclosure rules would be employed in connection with offerings in the United States, the civil liability and anti-fraud provisions of the federal securities laws continue to apply to all MJDS transactions.

The MJDS established various forms to be used primarily as a "wraparound" for the Canadian disclosure documents. Form F-7 is available for Securities Act registration in connection with rights offerings by eligible Canadian companies. Forms F-8 and F-80 are available in specified circumstances for Securities Act registration in connection with exchange offers and business combinations. Offerings by issuers of investment grade debt and preferred stock may be registered under the Securities Act on Form F-9. The debt or preferred stock must be rated investment grade (typically, the four highest ratings) by a nationally recognized statistical rating organization in order to qualify. No reconciliation of financial statements to U.S. GAAP is required for offerings on these forms.

Securities Act registration of other securities, including equity securities, is permitted on Form F-10. Form F-10 is also primarily a wraparound form for the Canadian disclosure documents, but reconciliation of financial statements to U.S. GAAP, as specified in Item 18 of Form 20-F, is required if the Form is filed within two years of the effective date of the MJDS. Thereafter, reconciliation is not required, absent future Commission action to the contrary.

Except in the case of rights offerings on Form F-7, the MJDS requires compliance by auditors with U.S. independence requirements only commencing with their report on financial statements for the most recent full fiscal year included in the initial registration statement on an MJDS form. For earlier periods, compliance with the ethics and independence standards of the issuer's home jurisdiction would be required unless U.S. auditor independence requirements otherwise applied.

A Canadian issuer that lists securities on a U.S. stock exchange or NASDAQ or that exceeds the Section 12(g) threshold of equity securities held of record by U.S. residents is eligible to use Forms 40-F (rather than Form 20-F) and 6-K to satisfy such registration or continuous reporting obligations under the Exchange Act if: (a) the issuer is eligible to use Form F-10; or

(b) the issuer is eligible to use F-9 and the securities could be registered on Form F-9. Canadian issuers that otherwise would incur an obligation to report under Section 15(d) by registering securities on Form F-7, F-8 or F-80 are exempt therefrom if the issuer is exempt from the obligations of Section 12(g) by virtue of Rule 12g3-2(b). Rule 12g3-2(b) contemplates the submission of home jurisdiction disclosure documents to the Commission by the issuer. Reporting obligations otherwise arising under Section 15(d) solely as a result of an issuer having filed a registration statement on Form F-7, F-8, F-9, F-10 or F-80 may be satisfied by filing on Forms 40-F and 6-K.

Information to be filed on Form 40-F includes the issuer's annual information form and audited annual financial statements with accompanying management's discussion and analysis, all as prepared in accordance with Canadian requirements. Reconciliation as specified in Item 17 of Form 20-F is required in connection with Form 40-F unless the obligation to file arises because of registration on Form F-7, F-8, F-9 or F-80 or the Form 40-F is filed with respect to securities that could have been registered under the Securities Act on Form F-9. Form 6-K information is that which the issuer has made public in its home jurisdiction, filed with a stock exchange where its securities are traded, or distributed to its shareholders.

In conjunction with the MJDS, the Commission also voted to adopt revisions to existing rules and forms to permit registration and reporting under the Securities Act and the Exchange Act by Canadian issuers on an equal basis with all other foreign issuers. Rules and forms restricting certain Canadian foreign private issuers, but not other foreign issuers, from use of the Commission's foreign integrated disclosure system for registration and reporting (Forms 20-F, F-1, F-2, F-3 and F-4) have been removed.

B. Limited Partnership Transactions - Interpretive Guidance and Rules

On June 17, 1991, the Commission issued an interpretive release providing guidance on disclosure with respect to limited partnership transactions (Rel. No. 33-6900). Among other things, the release provides guidance on the presentation of information, quality of disclosure, and updating information.

On October 30, 1991, the Commission adopted rules designed to enhance the quality and readability of information provided to investors in connection with limited partnership roll-up transactions (Rel. No. 33-6992).

Newly adopted Item 901(c) of Regulation S-K defines the term "roll-up transaction" to include, among other transactions, the merger of two or more limited partnerships into a new partnership, corporation, or real estate investment trust in which limited partners will receive a new security in a successor entity. The reorganization of a single partnership into corporate form also would constitute a roll-up transaction since it involves the issuance of new securities having substantially different rights and investment risks as compared to the subject partnership.

The new rules include a specific requirement to provide a clear, concise and comprehensible summary of the roll-up transaction. Specific disclosures are enumerated. The rules would require, among other things: (1) a description of the general partner's fiduciary duties to each partnership and each potential or actual material conflict of interest presented by the roll-up transaction, (2) a statement concerning whether or not an unaffiliated person was retained to represent investors in the roll-up, and if not, the risks arising from the lack of independent representation, (3) a statement by the general partner as to whether or not it reasonably believes the transaction is fair or unfair to investors in each partnership, specifically addressing each possible combination of partnerships, and (4) a discussion of the bases for the general partner's beliefs as to fairness, including a comparison of the roll-up transaction to alternatives, including liquidation and continuation of the partnerships. The rules also require a clear and concise summary description of each material federal income tax consequence of (1) the roll-up transaction for investors in each partnership and (2) an investment in the successor.

Specified financial information is required for each partnership: selected financial data pursuant to Item 302 of Regulation S-K; and for the same periods as that data: total assets at book value and at the value assigned for purposes of the transaction; total liabilities; general and limited partners' equity; cash and cash equivalents and change therein each period; net cash provided by operating activities; distributions; ratio of earnings to fixed charges; and

per unit data for net income or loss, book value, value assigned in the transaction, and distributions.

The rules specify that pro forma financial information (which should include pro forma reserve data in the case of oil & gas partnerships) should be presented showing the effect on the successor entity assuming (a) that all partnerships participate and (b) participation is limited to those having the lowest combined net cash provided by operating activities for the last fiscal year of such partnerships: balance sheet as of the later of the end of the most recent fiscal year or latest interim period; statements of income with separate line items to reflect income (loss) excluding and including roll-up expenses and payments, earnings per share amounts, and ratio of earnings to fixed charges for the most recent fiscal year and the latest interim period; statements of cash flows for the most recent fiscal year and the latest interim period; book value per share as of the later of the end of the most recent fiscal year or the latest interim period. Consideration should be given to the need to present other variations of participation that are permitted by the terms of the roll-up transaction.

In addition to the basic disclosure document, the rules require a separate disclosure supplement for each partnership involved in the transaction. The supplement must describe any material risks, adverse effects or benefits of the roll-up that are particular to each partnership. The supplement also must include detailed information about the valuation of the particular partnership for the roll-up transaction and a discussion of whether the sponsor reasonably believes the roll-up transaction is fair or unfair to investors in the particular partnership.

The rules require that roll-up disclosure documents be distributed to investors at least 60 calendar days in advance of a meeting, or the earliest date of partnership action by consent. If, under applicable state law, the maximum period permitted for giving notice is less than 60 calendar days, the state law maximum notice period would apply.

II. Recently Proposed Rules

A. Small Business Initiatives

On March 11, 1992, the Commission published for comment proposed revisions to the rules and forms under the Securities Act, Exchange Act, and Trust Indenture Act to facilitate capital raising by small businesses and reduce the compliance burdens placed on these companies by the federal securities laws (Securities Act Release No. 6924). The comment period for the proposed rules expires on June 18, 1992.

The Commission proposed significant revisions to the availability and operation of the Regulation A exemption. Regulation A would be extended to offerings up to $5 million, an increase from the present $1.5 million limit, and a new disclosure format -- the question-and-answer form now being used in over 20 states -- would be used in Regulation A offering documents.

To facilitate further the ability of small companies to raise seed capital, the Commission proposed amendments to Rule 504, one of the exemptive rules under Regulation D. Under current Rule 504, the Commission exempts from registration annual offerings of up to $1 million by non-Exchange Act reporting issuers. While Rule 504 does not restrict the kind or number of investors to whom the securities may be sold, it does limit the company's ability to engage in general advertising or other general offering activity. These limitations result in the investor receiving restricted securities, unless the securities are state registered. Similarly, state registration is required to rely on the exemption for securities offered in excess of $500,000. As proposed, a company could issue up to $1 million per year through sales of securities which could be freely traded without registration and without the conditions regarding state registration currently imposed by that Rule. As proposed, Rule 504 would permit general solicitation and general advertisement in connection with all offers and sales under the exemption.

The Commission also proposed to provide new disclosure requirements for use by small companies for both Securities Act registration and Exchange Act reporting requirements. The proposed forms would continue to require audited financial statements and narrative

disclosure of information necessary to make an informed investment decision. As in the case of Form S-18, GAAP financial statements will suffice; compliance with Regulation S-X will not be required. The disclosure requirements have been rewritten to be more easily understood by persons less familiar with the federal securities laws and regulations and, thus, reduce the filing costs for smaller companies. To facilitate this small business disclosure system, a new regulation containing all of the small business disclosure requirements, Regulation S-B, is proposed.

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

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

The proposals would amend Rules 3-19(b) and (c) to establish a scheme in which there will be no periods in which an offering could not go effective or during which continuous offerings would be suspended as long as the foreign issuer can provide audited fiscal year and unaudited interim financial statements within six months following the fiscal year end and four months following the end of the semi-annual interim period, respectively.

Rule 3-19(f) requires interim financial information that is made available to shareholders, exchanges or others on a more frequent basis than that required by Rules 3-19(b) and (c) to be included in any registration statement filed with the Commission. The rule requires this additional information to be reconciled to U.S. generally accepted accounting

principles (GAAP). The proposed amendments would provide that if a registration statement includes interim financial information which is more current than the latest reconciled annual or semi-annual financial statements, the later financial information need not be reconciled to U.S. GAAP provided that any material variation in accounting which was not previously disclosed and quantified in the reconciliation for an annual or semi-annual period is described and the quantified effects of the material variation are disclosed.

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

C. Multinational Tender and Exchange Offers

On June 5, 1991, the Commission issued a release (Rel. No. 33-6897) proposing rules that would permit tender offers for a foreign issuer's securities, whether subject to Section 12 of the Exchange Act or subject only to Section 14(e) and Regulation 14E of the Exchange Act, to proceed in the U.S. on the basis of the applicable regulation of the target company's home jurisdiction, where a small percentage of the shares sought are held of record by United States holders. Under the new procedures, offers eligible for the proposed exemptions would not be subject to the disclosure, filing, dissemination and minimum offering period requirements, proration and withdrawal rights, and other requirements of Rule 13e-4 and Regulations 14D or Regulation 14E, other than Rule 14e-3 insider trading prohibitions.

The conditions for reliance on the proposed rules would be: (1) that 10 percent or less of the class of securities sought in the tender offer are held by U.S. holders, other than U.S. holders of more than 10 percent of the subject class; (2) in the case of a

class of securities otherwise subject to Rule 13e-4 or Regulation 14D, that an English language translation of the offering materials be submitted to, not filed with, the Commission; (3) that U.S. securityholders are permitted to participate in the offer on terms not less favorable than those offered any other holders of the same class of securities sought in the offer; and (4) that dissemination of the tender offer, if required by the home jurisdiction, is provided to U.S. securityholders on a comparable basis. The procedures would be equally applicable to Regulation 14D and Regulation 14E offers, except those offers that would otherwise be subject solely to Section 14(e) and Regulation 14E, in which case no disclosure document would be submitted to the Commission, since a filing in such offers is not currently required.

D. Cross-Border Rights Offerings

On June 4, 1991, the Commission proposed for comment a new rule and a new registration form under the Securities Act to facilitate rights offerings by foreign private issuers to their existing U.S. shareholders (Rel. No. 33-6896). New Rule 801 would exempt from the registration requirements of Section 5 under the Securities Act the offer and sale in the United States of foreign equity securities in rights offerings in which the aggregate offering price does not exceed $5 million.

Rights offerings of foreign equity securities of any size, including those exceeding $5 million, may be registered on new Form F-11, using documents prepared according to the disclosure requirements of the issuer's home jurisdiction regulatory scheme. Reconciliation to U.S. GAAP would not be required, nor would compliance with U.S. auditing standards or U.S. accountant independence standards be required. Consents of experts and consents to service of process would not be required. Information that is permitted in the issuer's home jurisdiction to be incorporated by reference in the home jurisdiction prospectus may be incorporated by reference into the U.S. prospectus, provided that such document is filed as an exhibit to the registration statement on proposed Form F-11. Foreign issuers who do not otherwise have a reporting obligation under the Exchange Act would not, solely as a result of having filed a registration statement on proposed Form F-11 that has been declared effective, acquire such a reporting obligation.

E. Technical Amendments to Regulation S-X

On February 17, 1989, the Commission issued Release No. 33-6818 seeking comment on proposed amendments to various rules and forms needed to conform the Commission's requirements with recently adopted accounting standards. Since December 1986, the Financial Accounting Standards Board (FASB) has issued several Statements of Financial Accounting Standards (SFAS) that result in reporting requirements that are duplicative of, or in some instance, different from the Commission's requirements. The proposed amendments are intended to eliminate duplicative and obsolete disclosures and to achieve consistency between existing accounting principles and the Commission's rules, forms and policies.

The proposed amendments reflect reporting changes relating to adoption of SFAS No. 97, issued in December 1987, addressing accounting and reporting by insurance companies for certain long duration contracts and for realized gains and losses from sales of investments; SFAS No. 96, issued in December 1987, establishing a liability approach to accounting and reporting for income taxes; SFAS No. 95, issued in November 1987, requiring presentation of a statement of cash flows within a set of financial statements; and SFAS No. 91, issued in December 1986, prescribing new accounting for non-refundable fees and costs associated with originating or acquiring loans and initial direct costs of leases. The Commission also is proposing to delete Rule 4-10(k) of Regulation S-X that requires supplemental disclosures of oil and gas producing activities because substantially similar disclosure requirements are included in SFAS No. 69.

III. Other Accounting and Disclosure Issues of Current Interest

A. Executive Compensation Disclosure and Accounting

On February 13, 1992, Chairman Breeden announced that the Commission will undertake various initiatives with respect to the compensation of senior executives and directors. The recent increase in the number of shareholder proposals regarding executive compensation, and substantial public and Congressional concern over the issue, prompted re-examination of the staff's position that shareholder proposals on senior executive or director compensation should be excluded from issuer proxy statements on ordinary business grounds.

Henceforth the Commission will construe advisory proposals concerning senior executive or director compensation to be includable in proxy statements. The Chairman also announced that the Commission will propose for public comment revisions to its proxy rules designed to clarify and enhance the disclosure of current compensation packages. Finally, the Chairman indicated that the Chief Accountant will consider the adequacy of current accounting rules applicable to grants of stock options and report his findings to the Commission. Such report would take into account any impact new accounting rules would have on smaller, high-risk development stage companies.

B. Disclosures Regarding Debt Securities Accounted for at Amortized Cost

To facilitate meaningful analysis of the effect of accounting for debt securities at cost, the staff routinely requests the following disclosures by banks, savings and loans, thrifts, finance companies, insurance companies and similar institutions.

* The accounting policy note to the financial statements should clearly identify the characteristics that must be present for the institution to carry a security at amortized cost, rather than at market or lower of cost or market.
* Market value of the portfolio should be disclosed on the face of the balance sheet.
* Gross unrealized gains, gross unrealized losses, cost and market value should be disclosed for each pertinent category of debt securities in a note to the financial statements.
* Proceeds from the sales of securities should be distinguished from the proceeds of maturities in the cash flow statement or in a note thereto.
* Gross realized gains and gross realized losses on sales of securities should be separately disclosed in the MD&A. Disclosure in the financial statements is recommended.
* For the most recent balance sheet, the amortized cost and market value of securities due in one year or less, after one year thru five years, after five years thru ten years, and after ten years should be disclosed.
* MD&A should analyze and, to the extent practicable, quantify the likely effects on current and future earnings and investment yields and on liquidity, capital resources and regulatory compliance of: material unrealized losses in the portfolio; material sales of securities at gains; material shifts in average maturity. A similar analysis should be

provided if a material portion of fixed rate mortgages maturing beyond one year carry rates that are below current market.

* If sales out of the portfolio were significant, the MD&A should describe those events unforeseen at earlier balance sheet dates that caused management to change its investment intent.

* If a material proportion of the portfolio consists of securities that are not actively traded in a liquid market, MD&A or Business Description should include disclosure of the proportion and describe the nature of the securities and the source of market value information used for the financial statements. MD&A should include discussion of any material risks associated with the investment relative to earnings and liquidity. Similar disclosure should be furnished if the portfolio includes instruments the market values of which are highly volatile relative to small changes in interest rates and this volatility may materially affect operating results or liquidity.

* Investments held for sale, categorized by types of investments, should be presented separately from the balance of the investment portfolio in Table II, "Investment Portfolio", of Industry Guide 3 data. Contractual maturities of investments held for sale need not be presented.

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

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

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

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

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

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

D. Accounting and Disclosures Involving Lending Activities

A registrant engaged in significant lending activities should furnish information about its loan portfolio that is substantially similar to that customarily furnished by banks. In particular, registrants should consider the quantitative disclosures described in Sections III and IV of Industry Guide 3. This information includes loans by pertinent category, maturities, concentrations, risk elements, loan status and loss experience for a five-year historical period. Registrants are cautioned not to overlook disclosure of "potential problem loans" that are not otherwise required to be disclosed but involve problems which cause management to have serious doubts as to the ability of the borrowers to comply with loan terms.

Registrants should also consider the updating requirements of General Instruction 3(d) to the Industry Guide. In addition, notes to the financial statements should identify the circumstances under which accrual of interest on a loan is ceased, and amounts of interest that have not been accrued in accordance with loan terms should be disclosed.

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

Lenders in all industries should follow the guidance in FRR 401.09c regarding the accounting for substantively foreclosed assets. Collateral should be accounted for as substantively foreclosed if the debtor has little or no equity in the collateral (considering its current fair value), loan repayment can be expected to come only from the collateral, and it is doubtful that the debtor will rebuild equity in the collateral in the foreseeable future. Foreclosed collateral should be recorded at the lower of the loan's carrying amount or the collateral's fair value (discussed below) at the date of foreclosure, establishing a new cost basis for the property. Any excess of the carrying amount over fair value at that date should be recorded as a loss. Thereafter, the accounting principles for assets held for sale should normally be followed. Registrants should note that fair value, as defined by FASB 15, is the amount that the creditor could reasonably expect to receive for the asset in a <u>current</u> sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. The adoption of strategies (such as a hold-for-the-future strategy that is based on expectations of future price increases, or a strategy of operating the repossessed collateral for one's own behalf) cannot justify use of derived accounting valuations that portray results of operations more favorably than would use of current values in active markets.

E. Accounting and Disclosures for Letters of Credit

Letters of credit are a class of financial instruments for which disclosures are necessary pursuant to FAS 105. That standard requires disclosure of credit risk arising from letters of credit, measured as the amount of accounting loss the entity would incur if any party to the instrument failed completely to perform

according to the terms of the contract and any collateral proved to be of no value. A brief description of any collateral supporting the instruments is required, along with related disclosures. Group concentrations of the credit risk arising from letters of credit also must be disclosed pursuant to FAS 105. Groups of similarly affected credit risks for which disclosure is commonly required in Commission filings are identified in Section III.A. of the Industry Guide for banks, although registrants also should consider the guidance of Section III.C.(4) of that Guide.

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

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

F. Disclosures Regarding Risks Associated With Real Estate

If a significant portion of a registrant's operations involve developing, operating or otherwise investing in real estate or making loans collateralized by real estate, the description of the registrant's business in filings with the Commission should include information regarding the registrant's policies and practices with respect to selection of properties (types, locations, concentration limits), and assessments of impairments (frequency of appraisals, source of appraisals, methodologies employed, etc.). Notes to the financial

statements should clearly describe the registrant's accounting policies with respect to the carrying value of real estate assets: the circumstances under which an impairment is be recognized, the elements entering into the measurement of the asset's net realizable value, and the procedure for adjusting carrying value (ie., direct write-off or allowance, individual or portfolio basis).

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

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

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

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

* Other loans: If over 20% of offering proceeds (or total assets, if greater) have been or will be invested in a single loan (or in several loans on related properties to the same or affiliated borrowers), financial statements of the property securing the loan are required in '33 and '34 Act filings.

G. Environmental and Product Liability Loss Contingencies

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

The measurement of a liability for environmental clean-up should be based on currently enacted laws and regulations and on existing technology. A registrant should consider all available evidence including the registrant's prior experience in cleaning up contaminated sites, other companies' experience, and data released by EPA. The staff believes information necessary to support a reasonable estimate or range of loss may be available prior to the performance of any detailed remediation study. Estimates of costs associated with alternative remediation strategies may provide a reasonable basis to recognize a minimum probable loss.

Loss accruals established by some registrants have been reported net of expected recoveries from insurance carriers or other third parties. Recent litigation over insurance coverage and financial failures in the insurance industry indicate there may be significant uncertainties associated with estimated recoveries. Since the risks and uncertainties associated with the liability are different from those associated with any potential recovery from third parties, the staff believes that the liability and the recovery should be evaluated independently and disclosed separately either on the face of the balance sheet or in a note to the financial statements. Information necessary to an understanding of material uncertainties affecting both the measurement of the liability and the realization of recoveries should be furnished. This may include the

following: the extent to which unasserted claims are reflected in any accrual or may affect the magnitude of the contingency; the extent to which joint and several liability with other parties may affect the magnitude of the contingency; the extent to which disclosed but unrecorded contingent losses are subject to recovery through insurance; the extent to which insurance coverages are subject to dispute; and the effects on the company's liquidity and capital resources of expected expenditures in light of the expected timing of reimbursement by third parties.

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

H. Take-or-Pay Obligations of Gas Pipelines

Gas pipeline companies subject to take-or-pay obligations should provide sufficient information to enable an investor to understand the magnitude of the commitment and the nature and extent of uncertainties bearing upon the obligation's ultimate effect on future operations and liquidity. These disclosures typically include: (a) the registrant's accounting policies governing the provision for losses attributable to unfavorable pricing commitments and for current and potential claims under the contracts; (b) disclosure of the total dollar amount of suppliers' asserted and unasserted claims for deliveries not taken under take-or-pay contracts and for deliveries taken but for which the settlement amount is disputed; and (c) a schedule of commitments for each of the next five years and thereafter, in dollars, under contracts not having variable, market-based pricing, accompanied by an explanation of the extent to which provisions have been made for unfavorable pricing. Other information may be required if a material oversupply situation is reasonably possible.

In addition, the staff believes any liability recognized in connection with its take-or-pay

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

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

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

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

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

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

must make two assessments to determine what prospective information is required.

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

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

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

IV. Other Significant Disclosure Activities in the Division

A. Review of Filings

It its fiscal year ending September 30, 1991, the Division of Corporation Finance reviewed 2,660, or about 24%, of the publicly held issuers that file reports under the Securities Exchange Act of 1934. This was accomplished through the full reviews of 1,066 registration statements and post-effective amendments to registration statements; 188 merger and going private proxy statements; and 1,557 annual and other periodic reports. In addition to these full reviews, the staff completed 712 reviews of issuers' financial statements and MD&A contained in annual reports.

B. EDGAR

On January 3, 1989, the Commission awarded the contract to build the operational EDGAR system to the BDM Corporation, bidding with Mead Data Control, Inc., Sorg, Inc. and Bechtel Information Systems. On May 1, 1991, the operational EDGAR system was opened for receipt of test filings by EDGAR Pilot system filers.

The pilot project, which successfully demonstrated the feasibility of electronic filing, will continue until the operational system is complete. Then the volunteer participants in EDGAR Pilot will be phased into the operational system. Specific rulemaking proposals for the operational system are projected to be published in 1992. These proposals will reflect the comments received on the Commission's concept release concerning implementation of the EDGAR system (Rel. No. 33-6651; June 26, 1986).

On April 21, 1992, the Commission announced the adoption of amendments to the temporary rules and forms applicable to the EDGAR Pilot system (Rel. No. 33-6933). The Pilot filers are expected to move to the operational system on July 14, 1992. The first group of mandated filers will begin filing on operational EDGAR in July, October and December of 1993, with 750 filers phased in each month.

The operational system is expected to consist of the three subsystems: (a) Receipt and Acceptance ("R&A"); (b) Analysis and Review ("A&R"); and (c) Dissemination. Filings could be made into the R&A subsystem by direct transmission over telephone lines or by delivery of magnetic tapes or diskettes. The R&A subsystem would take the filing into EDGAR, notify the Commission and filers regarding acceptance and rejection, hold rejected filings in suspense and forward accepted filing to the A&R subsystem. Upon receipt of a filing from the R&A subsystem, the A&R subsystem would forward the filing to (a) an A&R Management System depository for long-term storage and Commission and public availability and (b) the Dissemination subsystem (provided it is a public filing). The Dissemination subsystem would make EDGAR information available to subscribers in various ways including direct connections to EDGAR, real-time feeds of filings as accepted, and overnight magnetic tapes containing the prior day's filings.

To promote one-stop filing, it is anticipated that the A&R subsystem would provide various self-regulatory organizations ("SROs"), such as the National Association of Securities Dealers and the exchanges and the states' agent, the North American Securities Administration Association ("NASAA"), with a direct feed of SRO-related and state-related filings in order of acceptance. The SROs and the states, through the NASAA, would be able to query the EDGAR public data base in a number of ways. These entities also would have the option to use the EDGAR electronic bulletin board to notify filers of the status of their SRO-related or state-related filing.

The Dissemination subsystem would make EDGAR information available to subscribers in various ways including direct connections to EDGAR, real-time feeds of filings as accepted, and overnight magnetic tapes containing the prior day's filings.

C. Financial Institutions Task Force

In early 1990, a task force consisting of up to ten staff accountants was established within the Division of Corporation Finance to conduct comprehensive accounting reviews of the financial statements, management's discussion and analysis, and other disclosures in the periodic reports of financial institutions. Transactional filings of financial institutions continue to be reviewed by branch personnel. This concentration of resources enables the Division to review a greater number of filings in this industry more quickly, to address incipient problems and to facilitate prompt identification of matters that warrant investigation by the Division of Enforcement's special unit.

More than 780 reviews had been completed at April 30, 1992. Significant staff comments on these reviews have encompassed areas including

* disclosures of regulatory capital requirements, actions and orders
* accounting and disclosures for debt securities held as investments
* accounting for non-performing loans, insubstance foreclosures and real estate owned
* adequacy and timing of provisions for losses on loans and real estate owned
* accounting for interest and fee income on loans and acquisition, development and construction arrangements

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

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

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

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

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

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

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

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

e. Other guidance:
   (1) If the aggregate of all "insignificant" businesses exceed 20% in any condition above, financial statements for the majority (combined if appropriate) should be furnished for most recent fiscal year and the latest interim period preceding the acquisition.
   (2) If the acquisition was consummated shortly after the most recent fiscal year and the registrant files its Form 10-K for that year before the due date of the Form 8-K (including the 60 day extension), significance may be evaluated relative to that fiscal year.
   (3) If the registrant has previously made a significant acquisition and it was fully reported on Form 8-K, significance test may be applied to that pro forma data rather than historical pre-acquisition data. The acquired business for which the test is made is not considered part of the registrant's base in determining significance.
   (4) If a registrant increases its investment in a business relative to the prior year, the tests of significance should be based on the increase in the registrant's proportionate interest in assets and net income during the year,

rather than the cumulative interest to date.

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

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

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

f. Registrants may request DCAO interpretation in unusual situations or relief where strict application of the rules and guidelines results in a requirement that is unreasonable under the circumstances.

3. Division or Lesser Component Acquired.

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

4. Special Rule Applicable to an IPO

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

B. Acquisitions Involving Troubled Financial Institutions

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

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

C. Financial Statements Relating to Third Party Credit Enhancements

Third party credit enhancements differ slightly from guarantees. A guarantee running directly to the security holder is a security within Section 2(1) of the Securities Act. A guarantor is a co-issuer under the Securities Act and provides required business and financial information and signs the registration statement. A third party credit enhancement is an agreement between a third party and the issuer or a trustee. A party providing credit enhancement generally is not a co-issuer. However, if an investor's return is materially dependent upon the

third party credit enhancement, the staff requires additional disclosure. The disclosure must provide sufficient information about the third party to permit an investor to determine the ability of the third party to fund the credit enhancement. In most cases, the third party's audited financial statements presented in accordance with generally accepted accounting principles would be required. However, if such financial statements are not available, alternative presentations may be acceptable. For example, statutory financial statements of insurance companies serving as credit enhancers may be accepted.

The staff considers the following factors in assessing the sufficiency of the disclosure in this area: (i) amount of the credit enhancement in relation to the issuer's income; (ii) duration of the credit enhancement; (iii) conditions precedent to the application of the credit enhancement; and (iv) other factors that indicate a material relationship between the credit enhancer and the purchaser's anticipated return.

D. Surviving Company in a Reverse Acquisition

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

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

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

The merger of a private operating company into a non-operating public shell corporation is considered by the staff to be essentially a capital transaction, rather

than a business combination. That is, it is equivalent to the issuance of stock by the private company for the net monetary assets of the shell corporation, accompanied by a recapitalization. The accounting is identical to that resulting from a reverse acquisition, except that no goodwill or other intangible should be recorded.

E. Redeemable Equity Securities

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

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

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

"sweetener" (amount in excess of the instrument's originally contracted redemption amount) was not considered in the EPS calculation.

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

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

If a distribution to owners (whether already reflected in the balance sheet or not, whether declared or not) is to be paid out of proceeds of the offering rather than from the current year's earnings, historical per share data should be deleted and pro forma per share data should be presented (for the latest year and interim period only) giving effect to the number of shares whose proceeds would be necessary to pay the dividend. For purposes of this SAB, a dividend declared in the latest year would be deemed to be in contemplation of the offering with the intention of repayment out of offering proceeds to the extent that the dividend exceeded earnings during the previous twelve months.

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

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

Paragraphs 61 - 64 of APB 15 require restatement of previously reported EPS to give retroactive effect to contingently issuable shares if the contingency is satisfied. If the conversion of outstanding securities to common stock or another dilutive security is contingent upon events occurring prior to or upon closing of an initial public offering, the staff believes EPS ordinarily should be calculated in the IPO as if that contingency were met.

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

If a conversion or term modification of outstanding securities will occur subsequent to the latest balance sheet date and the conversion will result in a material reduction of earnings applicable to common shareholders (excluding effects of offering), historical earnings per share should be deleted and only pro forma EPS for the latest year and interim period should be presented giving effect to the conversion (but not the offering).

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

In the Initial Offering Document: All stock, options and warrants issued within one year prior to filing of the registration of an entity's initial public offering of its equity securities are deemed outstanding for all periods presented (in the manner of a stock split), except that the registrant may assume that the difference between the IPO offering price and the amount received for the stock or the exercise price of the options is applied to repurchase outstanding shares in the manner of the "treasury stock method" outlined in APB 15. In periods prior to the offering, these securities should be deemed outstanding even if anti-dilutive (ie., when the registrant reports a loss).

In filings subsequent to the IPO: Stock, options and warrants deemed outstanding in the IPO pursuant to the SAB should continue to be deemed outstanding in all periods prior to the year in which the IPO is declared effective. In calculations of EPS for the fiscal year in which the IPO became effective, shares, options and warrants issued within one year prior to the IPO

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

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