Division of Corporation Finance

Accounting Disclosure Rules And Practices

An Overview

Training Material

2000 Edition (3/31/00)

U.S. Securities and Exchange Commission
Notice to Users of this Manual

The accompanying outlines are intended for use as training and review material, and should not be used as "review checklists.". Staff accountants should consult source literature before citing comments or advising registrants.

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Special Thanks to the Editor-in-Chief of the 2000 Edition: Melanie Dolan
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<td>ACRS</td>
<td>Accelerated Cost Recovery System</td>
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<td>AcSEC</td>
<td>Accounting Standards Executive Committee of the AICPA</td>
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<td>ADC</td>
<td>Acquisition, Development and Construction</td>
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<td>AICPA</td>
<td>American Institute of Certified Public Accountants</td>
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<td>AIN-APB</td>
<td>Accounting Principles Board Opinion Interpretation</td>
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<td>ARB</td>
<td>Accounting Research Bulletin</td>
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<td>ASR</td>
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<td>Codification of Statements on Auditing Standards</td>
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Topic One: REGISTRANT’S FINANCIAL STATEMENTS

I. Financial Statements and Schedules in Registrations and Proxy Materials

A. Audited Annual Financial Statements

1. Required audited financial statements for a domestic registrant in a registration statement or proxy materials:

<table>
<thead>
<tr>
<th>Statement</th>
<th>Regulation S-X [3-01, 3-02, 3-04]</th>
<th>Regulation S-B [Item 310]*</th>
<th>Special Notes</th>
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<tr>
<td>Balance Sheet</td>
<td>2 years</td>
<td>1 year</td>
<td></td>
</tr>
<tr>
<td>Income Statement</td>
<td>3 years</td>
<td>2 years</td>
<td></td>
</tr>
<tr>
<td>Stockholders’ Equity</td>
<td>3 years</td>
<td>2 years</td>
<td>May be presented in a note to the financial statements.</td>
</tr>
<tr>
<td>Cash Flow</td>
<td>3 years</td>
<td>2 years</td>
<td>Presented for same periods as an income statement. Required by SX 3-02 whether or not an audited balance sheet is presented for the period.</td>
</tr>
<tr>
<td>Comprehensive Income</td>
<td>3 years</td>
<td>2 years</td>
<td>Display with same prominence as other financial statements with reclassification adjustments displayed either on the face of the financial statement or in the notes to the financial statements.</td>
</tr>
</tbody>
</table>

* See Topic Five for S-B eligibility criteria.

NOTE: Financial statements included in Form 10-SB need only be audited for the most recent fiscal year if audited financial statements for the preceding year are not otherwise available. If this is the case, unaudited financial statements prepared in accordance with GAAP for the preceding year should be included in the filing. [Part F/S of Form 10-SB]

2. Exceptions and Special Cases

a) Form 1-A (available for qualifying small stock issuances) requires two years of financial statements. They may be unaudited unless the issuer is otherwise required to file audited statements with the Commission.
b) Unaudited fiscal year-end data may be provided if it is not otherwise required to be audited. [SAB 1C]

c) An income statement may be omitted if income and expense through the balance sheet date are nominal, but an audited footnote should summarize any activity. [SP]

d) A change in fiscal year requires transition period financial statements. Refer to III.E.

B. Unaudited Interim Financial Statements

Required unaudited interim financial statements [SX Article 10] for a domestic registrant to be presented in a registration statement made effective or a proxy statement mailed 135 days or more after the fiscal year-end:

<table>
<thead>
<tr>
<th>Statement</th>
<th>Regulation SX and SB</th>
<th>Special Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance Sheet</td>
<td>As of interim date within 135 days of effectiveness or mailing</td>
<td></td>
</tr>
<tr>
<td>Income Statement and Cash Flow</td>
<td>For period from the latest fiscal year end to the interim balance sheet date, and for the corresponding period in the prior fiscal year*</td>
<td></td>
</tr>
<tr>
<td>Stockholders’ Equity</td>
<td>For period from the latest fiscal year end to the interim balance sheet date</td>
<td>May be presented in a note to the financial statements.</td>
</tr>
<tr>
<td>Comprehensive Income</td>
<td>Same as income statement</td>
<td>Abbreviated disclosures may be presented in a note to the financial statements</td>
</tr>
</tbody>
</table>

* Corresponding prior year interim period not required in Form 1-A.

C. Supplemental Schedules [Article 12]

1. Required for fiscal years or year-ends as specified by the applicable article of Regulation SX.

2. Not required for SB filers or Form 1-A.

Not required in proxies, except certain schedules required for insurance and real estate companies. [PR Item 13 Instruction 3]

D. Proxy Materials

1. An annual report to shareholders containing audited financial statements for the most recently completed year must accompany or precede a proxy relating to an annual meeting at which officers and directors will be elected.
For what actions are financial statements required in proxy materials?

Financial statements are required where action is taken to authorize, issue, exchange or modify securities, or for a material merger or acquisition. For actions other than business combinations, financial statements are not required if they would not be material for the exercise of prudent judgment concerning the matter to be acted upon, like authorization or issuance of securities for cash. [Instructions to PR Item 13a.]

2. Business Combinations

In a proposed business combination, what financial statements are required in proxy materials?

The answer depends on who is voting and the nature of the consideration.

<table>
<thead>
<tr>
<th>Voting Shareholders</th>
<th>Consideration</th>
<th>Financial Statements</th>
</tr>
</thead>
</table>
| Acquirer only       | Cash only                              | Financial statements of the target are required since that information is material to a voting decision.  
• 3 years + interims under S-X  
• 2 years + interims under S-B  
Financial statements of the acquirer are not required, unless they are material to a voting decision, since shareholders are presumed to have access to information about their company.  
Pro forma information is required if it is material to a voting decision. |
| Acquirer only       | Exempt securities only or a combination of exempt securities and cash | Financial statements of the target are required since information is material to voting decision.  
• 3 years + interims under S-X  
• 2 years + interims under S-B  
Financial statements of the acquirer are not required, unless they are material to a voting decision, since security holders are presumed to have access to information about their company.  
Pro forma information is required if it is material to a voting decision. |
<table>
<thead>
<tr>
<th>Voting Shareholders</th>
<th>Consideration</th>
<th>Financial Statements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Target only</td>
<td>Cash only</td>
<td>Financial statements of the <strong>target</strong> are <strong>not</strong> required since security holders are presumed to have access to information about their company, <strong>unless</strong> it is a going private transaction. If the <strong>acquirer</strong> has demonstrated its financial ability to satisfy the terms of the transaction, its financial statements are generally not required. If required, need only 2 most recent fiscal years and interim periods. No <strong>pro forma</strong> information is required.</td>
</tr>
</tbody>
</table>
| Target only         | Exempt securities only or a combination of exempt securities and cash | Financial statements of the **target** are **not** required since security holders are presumed to have access to information about their company, **unless** it is a going private or a roll-up transaction. Financial statements of the **acquirer** are generally required since that information is material to a voting decision.  
• Need only 2 most recent fiscal years and interim periods. **Pro forma** information is required, if material. |

**NOTE:** If the consideration issued in the business combination includes **registered securities**, registrants must comply with the financial statement requirements of Form S-4 or Form F-4. See Topic Two.

3. Audit Requirement
The audit requirements for nonreporting target companies have been relaxed. Financial statements for the latest fiscal year must be audited if practicable. Financial statements for prior years need not be audited if they were not previously audited.
E. Bank Reorganizing under Newly-formed Holding Company

<table>
<thead>
<tr>
<th>Form</th>
<th>Financial Statement Requirements</th>
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<tr>
<td>Form S-4 to register common stock in exchange for all of a bank’s common stock in a transaction which satisfies all of the criteria stipulated in SAB 1F*</td>
<td>Financial statements may be omitted from a Form S-4, if the bank separately furnished to its shareholders financial statements prepared in accordance with GAAP (that need not be audited) for at least the most recently completed fiscal year. Similarly, Guide 3 data may be omitted from the registration statement.</td>
</tr>
<tr>
<td>First Annual Report on Form 10-K</td>
<td>Audited financial statements and Guide 3 data must be furnished for at least the two most recent fiscal years.</td>
</tr>
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* Generally, a reorganization with no changes in relative interests, no leverage, and no new classes of stock. In SAB 1F, “Form S-4” should be substituted for all references to “Form S-14”.

1. Registrants marking the box on the cover of Form S-4 that are in compliance with General Instruction G to the Form are declared effective automatically. Failure to check the box or to meet all of the conditions of General Instruction G means that the registration statement will not be declared effective automatically.

2. General Instruction G requires that the transaction being registered involves the organization of a bank or savings holding company for the sole purpose of acquiring the stock of a bank or savings institution in addition to the requirements in SAB 1F. If the purpose of the transaction includes other actions by shareholders, the registrant may not satisfy the conditions of Instruction G. Even though the registration statement is not declared effective automatically, financial statements may not be required provided all of the conditions of SAB Topic 1F are met.

F. Recently Organized Registrant [SP]

| In a filing to be made effective before the registrant is capitalized on other than a nominal basis: | Registrant financial statements may be omitted unless the registrant will acquire or otherwise succeed to a business for which financial statements are required to be included. If omitted, the prospectus should include a statement that the entity has not commenced operations and has no (or nominal) assets or liabilities. Contingent liabilities and commitments should be described in sufficient detail. |
If the registrant is a “shell” into which an operating company will be recapitalized: Registrant financial statements may be omitted. Complete audited financial statements of the operating company (as predecessor of the registrant) must be provided.

**Example:** A company wants to change its state of incorporation in order to facilitate an IPO. To do that, a new corporation incorporated in Delaware (Newco) was formed and all of the shareholders of the company will exchange their equity ownership interests in the company for identical ownership interests in Newco. Separate financial statements of Newco are not required in the registration statement.

If the registrant will succeed to a business in a transaction that is not a reorganization: Include the financial statements of both the acquired/predecessor business and the registrant in the filing.

### What is a “shell” company?

A “shell” company is an entity with minimal net assets and operations.

#### G. Predecessor Financial Statements

Financial information of a registrant’s predecessor is required for all periods prior to the registrant’s existence, with no lapse in audited periods or omission of other information required about the registrant. Any interim period of the predecessor prior to its acquisition by the registrant should be audited when audited financial statements for the period after the acquisition are presented. Schedules required by SX Article 12 are required for predecessor entities.

**What is a predecessor entity?**

The definition of "predecessor" at RC 405 is very broad. For purposes of financial statements, the staff generally does not require designation of an acquired business as a predecessor 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 prior to the succession appear insignificant relative to the operations assumed or acquired. [SP]

#### H. Development Stage Company [FAS 7]

1. **What is a development stage company?**

   It is an entity that is devoting substantially all of its efforts to
establishing a new business and either its planned principal operations have not commenced, or (b) its planned principal operations have commenced but have not yet generated significant revenues.

2. **Financial statements required** to be presented for a development stage company:

   a) Statements identified as those of a development stage company. The first year after exiting the development stage, the company should disclose that it is no longer a development stage company.

   b) Balance sheet with cumulative net losses described as “deficit accumulated during the development stage.”

   c) Income and cash flows statements for each period, plus a cumulative income statement from inception.

   d) Statement of stockholders’ equity showing each issuance of stock since inception.

   e) Ordinarily, a development stage company may omit financial statements of the prior comparable interim period. However, if the registrant remains in the development stage more than two years, comparable period information may be necessary to evaluate trends in administrative and other costs. [SP]

   **NOTE:** Auditor association with the cumulative data is required on an annual basis as long as the registrant is in the development stage. If the cumulative column in a registration statement includes results from an unaudited interim period subsequent to the latest audited balance sheet date, the auditor’s report need not make reference to the cumulative data. The staff will consider requests for waiver of the requirement for audit of the cumulative data in annual statements where it is impracticable to obtain that audit.[SP]

I. **Supplemental Financial Statements**

If a material business combination to be accounted for using the pooling-of-interests method has been consummated after the latest balance sheet date and post-combination operating results have not been published, a registrant may not reflect the business combination in its financial statements. However, the registrant may elect to provide, and may be required to provide in connection with registration statements or proxies, supplemental audited financial statements giving effect to the pooling of interests. See Appendix C for guidance applicable to supplemental or restated financial statements as a result of post-balance sheet events, including transactions accounted for in a manner similar to a pooling of interests.
II. Age of Financial Statements in a Registration Statement or Proxy

[SX 3-12, SB 310(g)]

A. Staff Review

1. Staff should not commence review of a filing unless the registrant’s financial statements comply with the rules for age of financial statements and audit at the date of filing. The staff should evaluate compliance immediately upon assignment for review.

2. In certain circumstances, the staff will consider an issuer’s special processing needs for a transaction. However, the issuer is expected to discuss their particular needs with the Division's staff in advance of filing.

B. Age Requirements

1. The following applies to both SX and SB filers.

   a) General Rule Latest balance sheet must be as of a date less than 135 days (or 180 days on Form 1-A) before the effective date of the registration statement (or date the proxy is mailed).

      Example: A Form S-1 with an audited December 31, 1997 balance sheet (fiscal year-end) can not be declared effective after May 14, 1998 without updating.

   b) Rule for Initial Filers A registration statement should not be declared effective later than the 134th day after the latest balance sheet date, except that third quarter data is timely through the 45th day after the most recent fiscal year-end. After the 45th day that fiscal year must be audited. SB issuers may be declared effective with third quarter financial information up to 90 days after year-end if the issuer expects to report income in the current year and has reported income in at least one of the two previous years.

      Example: A Form S-1 for a registrant with a calendar year-end with an interim balance sheet as of the end of the first quarter (March 31) can not be declared effective after August 12 without updating. A Form S-1 for a calendar year-end registrant with an interim balance sheet dated September 30 can not be declared effective after February 14.
c) Year-end Rule for Repeat Filers

Repeat issuers do not need to update third quarter interim financial statements until the 90th day after their fiscal year end, if they satisfy the 3 conditions of SX 3-01(c) [SB 310(g) for SB filers]:

- Filed all Exchange Act reports due,
- Expect to report income in the year just completed, and
- Reported income in at least one of the two previous years.

Unless all three conditions are met, registration statements declared effective after the 45th day following the fiscal year end must include audited financial statements for the most recent fiscal year end. A repeat issuer that has not filed its first Exchange Act report since an initial offering has not met condition (1) above.

**NOTE:** If the audited financial statements for the most recently completed fiscal year are available or become available prior to effectiveness or mailing, they must be included in the filing.

d) Newly formed registrant

Audited financial statements are required as of a date less than 135 days before the **initial filing date** of the registration statement. Subsequent updates to comply with the 135 day rule may be made on an unaudited basis, except that audited financial statements are required if the registration statement is to be made effective more than 45 days after the company’s fiscal year end. [SX 3-01(a)]

**Example:** A registrant with a December 31, 1997 year end was formed on May 1, 1997. A Form S-1 is filed on November 5, 1997. The Form S-1 must contain an audited balance sheet dated June 24, 1997 or later.
### e) Accommodation for timely filers

The staff will declare a registration statement effective if:

- interim financial statements in the filing are at least as recent as the quarterly information that has been filed as required by the Exchange Act at the time of effectiveness, and
- the filer has filed all of its Exchange Act reports in the last 12 months in a timely fashion.

However, the issuer must confirm that the quarterly report will be timely filed after effectiveness and that there have been no material trends, events or transactions that arose subsequent to the date of the latest balance sheet included in the filing that would materially affect an investor’s understanding of the registrant’s financial condition and results of operations. A description of these items in the next quarter ordinarily will not suffice.

**Example:** A Form S-3 eligible registrant with a calendar year-end files a registration statement containing interim period financial statements as of June 30. Interim period financial statements as of September 30 would ordinarily be required under the 135 day rule on November 12. Since the registrant’s September 30 Form 10-Q would not be due until November 14 (45 days after September 30), the Form S-3 may be declared effective on November 12 or November 13 provided that the above representations are made.

### f) Continuous and Shelf Offering

A prospectus must be updated by post-effective amendment if it is in use beyond nine months after its effective date and if the audited balance sheet is more than 16 months old. [33A-10(a)(3) & RC 427]

### g) Proxies

Same as the guidance for registration statements, except substitute the date of mailing for date of effectiveness.

### h) Combination Form S-4 / Proxy

Age of financial statements is determined with reference to the date of effectiveness of the Form S-4 and not the mailing of the proxy, unless mailing is delayed beyond the time necessary to prepare the material for mailing (generally no more than a few days after effectiveness of the S-4).
i) Forms 10 and 10-SB  Age of financial statements is determined by reference to the effective date of the filing. See Section III.A.4 for discussion of automatic effectiveness.

**NOTE:** During the period between initial filing and effectiveness, a registrant may update financial statements by amending the registration statement or by filing the applicable Exchange Act form (e.g. Form 10-Q). [SP]

j) Post-effective Amendments  All post-effective amendments that revise the prospectus are considered “new filings” and need to include updated financial statements meeting the requirements of Regulation SX at effectiveness of the amendment. [SK 512]

**NOTE:** Amendment of a registration statement to provide an exhibit does not amend the prospectus.

k) Sticker Supplements and Post-effective Amendments consolidating Sticker Supplements for Real Estate  Sticker supplements and post-effective amendments that consolidate supplements are not considered new filings for purposes of updating the registrant’s financial statements if they are filed by real estate companies pursuant to Undertaking D of Guide 5 solely for the purpose of providing the financial statements of acquired properties. [R33-6405]

l) Effect of Holiday or Weekend  If the last day of the period after which financial statements must be updated (that is, the 134th day after the first, second, or third quarter-end, or the 45th or 89th day following a fiscal year end) falls on a Saturday, Sunday or holiday, the filing may be made on the next following business day without updating the financial statements [RC 417]. The same rule holds true when an Exchange Act filing due date falls on a weekend or holiday. [EAR 0-3]

2. Circumstances in which the staff or the registrant believes relief from rules governing age of financial statements is appropriate should be brought to the attention of DCAO.
III. Periodic Reporting Requirements (Exchange Act Filings)

A. Companies Required to Report

1. If a company has registered an offering of securities under the Securities Act, that Company is required to file reports for periods ending after the date of the last balance sheet included in the registration statement. [EAR 15d]

2. Companies are required to register securities and file periodic reports if they:
   - have 500 or more shareholders and $10 million or more of assets as of the latest fiscal year-end [EAS 12(g)],
   - OR
   - have shares traded on a national exchange. [EAS 12(b)]

3. A Company already reporting pursuant to Sections 13 or 15(d) may register under Section 12 of the Exchange Act by filing Form 8-A. Other U.S. companies must register on Form 10 (foreign companies register on Form 20-F). A Form 8-A filed concurrently with a Securities Act registration statement becomes effective automatically on the later of the filing of the Form 8-A, the effective date of the registration statement, or, if the securities will be listed on a U.S. stock exchange, receipt by the Commission of certification from the exchange.

4. Certain registration statements go effectively automatically as follows:

<table>
<thead>
<tr>
<th>If Filed Under:</th>
<th>Registration Statement Goes Effective:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Section 12(g)</td>
<td>60 days after the initial filing, or earlier if acceleration is requested and granted.</td>
</tr>
<tr>
<td>Section 12(b)</td>
<td>30 days after certification by the applicable exchange or earlier if acceleration is requested and granted.</td>
</tr>
</tbody>
</table>

5. A Company may suspend its reporting requirement by filing a Form 15 if [EAR 12h-3, 12g-4]:
   - the Company has less than 300 shareholders and has filed at least one Form 10-K (not including a Special Report), OR
   - the Company has:
     a) Fewer than 500 shareholders,
     b) Less than $10 million in assets for the last three fiscal year-ends, and
     c) Has filed at least three Form 10-K’s since the most recent registered offering of its securities.
B. Financial Statements Required

<table>
<thead>
<tr>
<th>Forms 10 and 10-SB (for registration under Section 12)</th>
<th>Same as described at I.A and B.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forms 10-K and 10-KSB (Annual Reports)</td>
<td>Same as described at I.A.</td>
</tr>
<tr>
<td>Forms 10-Q and 10-QSB (Quarterly Reports)*</td>
<td>Same as described at I.B plus:</td>
</tr>
<tr>
<td></td>
<td>• Balance sheet as of last fiscal year-end for Form 10-Q only; and</td>
</tr>
<tr>
<td></td>
<td>• Statements of income for most recent quarter alone, and prior comparable quarter alone (a statement of cash flows for these quarters is not required).</td>
</tr>
</tbody>
</table>

* Financial statements may be condensed and must be reviewed by an independent accountant prior to filing as described in SX Article 10.

1. Special Reporting Cases

a) Inactive registrants may provide unaudited financial statements in Form 10-K.

What is an inactive registrant?

A registrant whose gross receipts or expenditures do not exceed $100,000; no purchases, sales or distributions of securities; and no material changes (no bankruptcy, reorganization, etc.) (SX 3-11).

b) Registrants Operating under the Protection of Bankruptcy Laws

(1) Such registrants may obtain relief from certain Exchange Act reporting requirements by writing to OCC prior to the due date for filing the report in which relief is requested. In certain circumstances, OCC has taken a no-action position when a registrant has filed only the information it filed with the Bankruptcy Court. See Staff Legal Bulletin 2.

(2) If relief is granted for filings while operating under the protection of the bankruptcy laws, the registrant is required to file an audited balance sheet as of the date of emergence.

(3) Even if prior relief from Exchange Act reporting obligations is granted, a subsequent Securities Act registration statement will not be declared effective if audited financial statements for all periods required by the Form, including pre-emergence periods, are not included. A registrant that has filed only Bankruptcy Court filings under relief would not be
considered “current” in its Exchange Act reporting for Form S-2 or Form S-3 eligibility purposes.

c) Mutual life insurance companies and certain mining companies in the exploratory stage are exempt from Part I disclosures required by Form 10-Q [EAR 13a-13(b)].

C. Due Dates

1. Exchange Act reports are due as follows:

<table>
<thead>
<tr>
<th>Report Type</th>
<th>Due Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual reports (Forms 10-K and 10-KSB)</td>
<td>90 days after the fiscal year-end.</td>
</tr>
<tr>
<td>Quarterly reports (Forms 10-Q and 10-QSB)</td>
<td>45 days after the quarter end.</td>
</tr>
<tr>
<td>Other disclosures reportable under Form 8-K</td>
<td>15 days after the event, except for changes in accountants and resignations of directors, which must be reported within 5 business days.</td>
</tr>
</tbody>
</table>

2. Automatic extensions of due dates for periodic reports are available (up to 5 calendar days for quarterly reports and 15 calendar days for annual reports) if all or any portion of the report cannot be filed timely without unreasonable effort or expense. A registrant must file Form 12b-25 no later than one day after the due date of the form for which relief is requested. No further extensions are available.

3. After a registrant’s first registration statement is declared effective, a Form 10-Q for the quarter following the period included in the registration statement is due the later of 45 days after effectiveness or the date the Form 10-Q would otherwise be due. [EAR 15d-13]

   **Example:** If a registrant’s fiscal quarter ended June 30 and the registration statement went effective on July 14, the Form 10-Q for the quarter ended June 30 is due 45 days from July 14, which is August 28. If the registration statement went effective on June 24, the Form 10-Q is due on the date it would ordinarily be due (45 days from the end of the quarter), which is August 14.

4. When an IPO is made effective within 45 days (90 days for a Small business Issuer) after the fiscal year-end, but does not include the audited statements of the just recently completed year, the following reporting requirements apply:
If the registrant files a Form 8-A to register under Sections 12(b) or 12(g) of the Exchange Act

File an Annual Report on Form 10-K within 90 days after its fiscal year-end.

If the registrant is subject to the Exchange Act reporting requirements by virtue of Section 15(d)

File a Special Report* on Form 10-K within 90 days of effectiveness containing audited statements for that year. A complete Annual Report on Form 10-K is not required until the following fiscal year. [EAR 15d-2]

*This Special Report does not need to include MD&A or other narrative disclosures ordinarily required in a Form 10-K, but registrants are encouraged to provide that information. To comply with rules of the exchange on which they are listed (not Commission rules), companies may need to file a complete Form 10-K, rather than a special report. Even if omitted from a special report, MD&A and other omitted information would need to be included in any subsequent registration statement or proxy statement.

D. Length of Fiscal Year

1. Fiscal years may not exceed 12 months. Under SX 3-06, nine to twelve months of audited financial statements will meet the requirement for one year of audited financial statements:
   - for financial statements of an acquired business,
   - or
   - when a registrant has changed its fiscal year (see immediately below).

   **NOTE:** These criteria also apply to SB filers.

2. A registrant can not substitute nine months of results in satisfaction of a requirement for one year in other circumstances without prior consultation with DCAO.

E. Changes in Fiscal Year

1. When a company changes its fiscal year it is required to file a report covering the transition period. [EAR 13a-10, 15d-13 & FRC 102.05]

   **What is a transition period?**

   The period between the closing of the registrant’s most recent fiscal year and the opening date of its newly selected fiscal year.
2. Transition reporting requirements are as follows:

<table>
<thead>
<tr>
<th>If the transition period is:</th>
<th>File a transition report:</th>
</tr>
</thead>
<tbody>
<tr>
<td>6 months or more</td>
<td>On Form 10-K within 90 days after the later of the election to change the fiscal year or the end of the transition period. The transition period financial statements must be audited.</td>
</tr>
<tr>
<td>Less than 6 months</td>
<td>On Form 10-K as above, or on Form 10-Q within 45 days after the later of the election or transition period-end. The transition period may be unaudited in Form 10-Q, but the next Form 10-K must contain audited financial statements of the transition period.</td>
</tr>
<tr>
<td>One month or less</td>
<td>No separate filing is required. However, the one month transition period must be audited and included in the next Form 10-K.</td>
</tr>
</tbody>
</table>

3. Other notes regarding changes in fiscal periods:

a) Transition reports must include **prior year information** comparable to the transition period. Comparable year information may be unaudited and may be provided on a condensed basis and in the footnotes to financial statements instead of separate statements. [FRR 35] All information responsive to the textual items of the reporting form (i.e., SK Items 101, 103, and 303 for Form 10-K) must be provided in the transition report. [FRR 35]

b) No audited reporting period, **under any circumstances**, may exceed 12 months for domestic issuers.

c) Even if an issuer complies with Exchange Act requirements following an election to change the fiscal year, **it may be required to provide more current audited financial statements in a Securities Act registration statement** by the form’s instructions.

d) A business combination accounted for as a **reverse acquisition** may result effectively in a change in fiscal year. See Appendix B.
IV. General Considerations (All Filings)

A. Basis of Reporting

1. Regulation S-X and GAAP must be followed. Financial statements not prepared in accordance with GAAP are presumed to be inaccurate or misleading. [SX 4-01(a)(1)] **Exceptions to compliance with S-X are:**

   a) Small Business Issuer
      Follow Regulation S-B and not S-X. S-X differs from GAAP and S-B primarily in its requirement for supplemental schedules and in its designation of specific formats and quantitative levels of materiality for many disclosures. Auditor reporting and independence requirements of SX Article 2 and the full cost oil and gas disclosures required by SX 4-10 apply to Small Business Issuer forms. Small business issuers should comply with the requirements of SB 310(d), but may wish to consider the guidance in SX Article 11.

   b) Annual Report to Shareholders
      Does not need to include the separate financial statements, pro forma data, or schedules required by Articles 3, 11 and 12 of Regulation SX, or predecessor audit reports. [PR 14a-3]

   c) Royalty Trusts
      May report on a different basis pursuant to SAB 12E.

   d) Mutual life insurance companies
      May present financial statements on statutory basis. [SX 7-02] For periods after December 31, 1995, statutory basis financial statements can no longer be characterized as being in conformity with GAAP. However, a mutual insurance company converting to stock form must follow GAAP for stock companies for all periods presented.

B. Consolidated Financial Statements [SX 3A-02]

Generally, **majority owned subsidiaries** should be consolidated but that presumption may, in some circumstances, be overcome. Careful analysis of the facts and circumstances should be applied to evaluate the existence of a controlling financial interest equivalent to majority ownership of voting stock, notwithstanding the absence of legal ownership of a majority of voting stock. [FRC 105, ARB 51, FAS 94 and EITF 96-16]
Certain changes in equity ownership are reflected in the financial statements as follows:

<table>
<thead>
<tr>
<th>Condition</th>
<th>Accounting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change from consolidation or equity method to cost method.</td>
<td>Results in the establishment of a new cost basis, prospectively. For periods prior to the change, continue to present the investment on a consolidated basis or under the equity method, whichever was applicable.</td>
</tr>
<tr>
<td>Change from equity method to consolidation or from consolidation to equity method.</td>
<td>Usually NOT reflected retroactively. Change is accounted for prospectively from the date of change. Generally, the staff has not objected to retroactive presentation from the beginning of the fiscal year in which the change occurs. It is generally inappropriate to restate prior fiscal years, although pro forma information may be useful in MD&amp;A.</td>
</tr>
<tr>
<td>Change from cost method to equity method.</td>
<td>Typically reflected on a retroactive basis in the financial statements. [APB 18.19]</td>
</tr>
</tbody>
</table>

C. Guaranteed Securities

A guarantee of a security is considered a security, and the guarantor is subject to the reporting and registration requirements applicable to other issuers. Relief from separate reporting and financial statement requirements is available for guarantors in certain limited circumstances. [See Topic Two, IV.A]

D. Liquidation Basis Financial Statements

In unusual circumstances it may be appropriate to present financial statements on a liquidation basis. Audit reports on those statements are described in AU 9508.33-37.

E. Fiscal Years Differing by 93 Days or Less

1. Consolidation of a parent and subsidiaries with year-end differences not exceeding 93 days is permissible (accompanied by disclosure of the different closing date and its justification). However, intervening events that materially affect financial position or operating results should be disclosed. [ARB 51] Where fiscal years differ by more than 93 days, statements of the subsidiary should be adjusted to a period that more nearly corresponds with the fiscal period of the parent.

2. In connection with a retroactive combination of financial statements of an entity following a pooling, the financial statements of the combining entities may be combined even if their respective fiscal periods do not end within 93 days of each other. However, in this instance the financial statements of the latest fiscal
year (i.e., the fiscal year in which the pooling is consummated) shall be recast to
dates which do not differ by more than 93 days. The “catch-up” period is
reflected as an adjustment to shareholders’ equity. In the absence of other
circumstances, where practicable, we believe that the most preferable presentation
usually will combine twelve sequential months of the conforming company’s
results while minimizing the number of days that are omitted from, or counted
twice in, the restated financial statements. The staff will object to methods of
retroactively combining the financial statements that do not result in a fair
representation of historical results of the combined entities.

3. Financial Statement Disclosures

a) The periods combined and the revenues, net income before extraordinary
items and net income of any interim periods excluded from, or included more
than once in, the results of operations as a result of recasting;

b) The operating, investing and financing cash flows of any interim period
excluded from, or included more than once in, the recast financial statements
on the face of the statement of cash flows, or in the notes to the financial
statements; and

c) Any additional quantitative and narrative disclosure about gross profit, selling
and marketing expenses, and operating expenses necessary to inform readers
about the effects of unusual charges or adjustments in the omitted or double
counted period. [SX 3A-02]

F. Partnerships [SAB 4F]

1. Consolidation and Equity Method Accounting

Partnerships controlled by the registrant should be consolidated. [SOP 78-9, EITF
Topic D-46 and TPA 1400.13 & 1400.19] Limited partnership interests owned
by the registrant generally should be accounted for under the equity method,
unless the investor’s interest is so minor that the limited partner may have
virtually no influence over the partnership's operating and financial policy.
Investments of more than 3%-5% generally are considered to be more than minor.

2. Financial Statement Presentation

<table>
<thead>
<tr>
<th>Equity Section of the Balance Sheet</th>
<th>Statement of Changes in Equity</th>
<th>Statements of Income &amp; Comprehensive Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Distinguish between amounts ascribed to each ownership class (i.e. GP vs. LP’s), with authorized and outstanding units disclosed for each class.</td>
<td>Present for each class.</td>
<td>Show net income allocable to each class, with results of operations and comprehensive income reported on a per unit basis.</td>
</tr>
</tbody>
</table>
3. **Taxable income** should be disclosed in a reconciliation from GAAP net income. [SP]

**G. Quasi Reorganizations [TPA 4220, SAB 5S, FRC 210]**

1. Fair market valuation of assets and liabilities should not result in a net asset value exceeding that reported prior to the quasi-reorganization. Any reorganization value in excess of previously reported net assets should be treated as a reduction of goodwill, then other intangibles, then other non-current assets.

2. Registrants are required to recognize liabilities under FAS 87 and FAS 106 in a quasi-reorganization, as well as other liabilities that would be recognized in allocation of purchase price in a business combination.

3. For a period of at least ten years subsequent to the effective date of a quasi-reorganization, any description of retained earnings should indicate the point in time from which the new retained earnings dates. Indicate the total amount of deficit eliminated on the face of the balance sheet for a period of time of at least three years. [SX 5-02.31.b]

**H. Miscellaneous Considerations**

1. **Fiscal Year-end.** Presumed to be calendar year-end if no closing date has been adopted. [SX 1-02(k)]

2. **Ordering of Fiscal Year Data.** Consistent chronological order generally should be followed in presentation of financial data throughout the filing to avoid confusion. [SAB 11E]

3. **Substance Over Form-Financial.** Accounting should emphasize the economic substance over legal form. [AU 9411.11] However, legal form may be decisive with respect to matters involving control, liability, ownership and other factors that are central to the substance of a transaction. In addition, accounting literature specifically prescribes certain treatments on the basis of the form of the transaction (for example, pooling-of-interest method).

4. **Staff Accounting Bulletins.** Should be applied to analogous circumstances.

5. **GAAP Hierarchy.** Registrants should apply the hierarchy of GAAP literature as defined at AU 411.10.

**I. Materiality**

1. Defined as a matter about which an average prudent investor ought reasonably to be informed. [SX 1-02(o)] A matter is material if there is a substantial likelihood that a reasonable person would consider it important.
2. If an item otherwise required by SX is not material, it need not be presented separately. Inapplicable items of SX need not be followed, but the reasons for omission should be clearly stated. [SX 4-02 & 03]

3. SX Article 5 applies a materiality level of 5% of current assets and liabilities and 5% of total assets and liabilities for caption display.

4. For purposes of assessing a financial statement misstatement, the use of a numerical threshold, such as 5%, may provide the basis for a preliminary assumption that -- without considering all relevant circumstances -- a deviation of less than the specified percentage with respect to a particular item on the registrant’s financial statements is unlikely to be material. The staff has no objection to such a “rule of thumb” as an initial step in assessing materiality. But quantifying, in percentage terms, the magnitude of a misstatement is only the beginning of an analysis of materiality; it cannot appropriately be used as a substitute for a full analysis of all relevant considerations. [SAB 1M]

5. Materiality must not be considered just in terms of a numerical or percentage misstatement. The “total mix” of information should also be considered. The total mix includes not only numerical or percentage terms of misstatement, it also includes the factual context in which the user of financial statements would view the financial statement item. Factors that may affect the materiality of a quantitatively small misstatement include, but are not limited to, the following:

- degree of precision inherent in an estimate
- a change in earnings or other trends
- failure to meet analysts’ consensus expectations for the enterprise
- change from a loss to income or vice versa
- effect on a segment identified as playing a significant role in the registrant’s operations or profitability
- compliance with regulatory requirements
- compliance with loan covenants or other contractual requirements
- effect on management’s compensation
- concealment of an unlawful act

[SAB 1M]

6. When changes in accounting occur or accounting errors are identified, their materiality should be considered in relation to both the effects of each change separately and the combined effect of all changes. If a change or correction has a material effect on results of the current period, the guidance of APB 20 should be followed. A change which does not have a material effect in the period of change but is reasonably certain to have a material effect in later periods should be disclosed whenever the financial statements of the period of change are presented. [APB 20]

7. Assessments of materiality of liabilities should not be made on a "net" basis after consideration of related receivables and other claims unless a right of setoff exists.
Assets and liabilities may not be offset unless a right of setoff exists. The conditions for right of setoff are found in FIN 39 and discussed in SAB Topic 5Y.

* * * * *
**Topic Two: OTHER FINANCIAL STATEMENTS REQUIRED**

This topic identifies circumstances in which financial statements of entities other than the registrant are required to be included in filings. The guidance applicable to financial statements of the registrant (in Topic One) applies also to financial statements of the other entities, unless specified otherwise in this section.

**I. Businesses Acquired or To Be Acquired**  
[SX 3-05, SB 310, Form S-4]

**A. Financial Statement Requirements**

1. Financial statements of acquired businesses are required as follows:

<table>
<thead>
<tr>
<th>Form</th>
<th>Financial Statement Requirements</th>
</tr>
</thead>
</table>
| Registration Statements and Proxies | a) If less than 50% significant, financial statements of a business acquired or likely to be acquired need not be included unless the registration statement is declared effective (or proxy is mailed) 75 days or more after the acquisition is consummated. Refer to I.D and I.E for tests of significance. This rule does not apply to “blank check” issuers.  
   b) If 50% or greater significant, financial statements of a recent or probable acquisition are required.  
   c) Certain types of offerings may proceed even if the acquisition exceeds the 50% level (conversions, warrants or rights, Drips, benefit plans, secondary offerings, sales pursuant to Rule 144). [Instruction 1 to Item 7 of Form 8-K ] |
| Form 8-K              | (a) Form 8-K reporting the transaction is required within 15 days of the consummation of any business acquisition meeting the 20% significance level or for any asset purchase exceeding 10% significance that does not meet the definition of a business.  
   (b) If the required financial statements of the business acquired are not provided with the initial report, they must be filed by amendment within 75 days after consummation of the acquisition. |

**NOTE:** While a Form 8-K is not required for business acquisitions until the 20% significance level, registrants may elect to report business acquisitions below 20% pursuant to Item 5 of Form 8-K even if financial information is not provided.
2. The requirements of SX 3-05 and SB 310(c) apply only to acquisitions made by
the registrant or its predecessor(s). Those rules call for financial statements of the
acquiree and its predecessor(s), if applicable. Financial statements of businesses
recently acquired by the acquiree need not be furnished unless their omission
would render the acquiree's financial statements misleading or substantially
incomplete. [SP]

NOTE: A flowchart to assist you in determining the need for financial
statements of an acquired business in a registration statement is located at the
end of this Topic.

3. Definitions and Requirements

a) **Financial statements** of the acquired business are generally the same as
those as if the acquired company were a registrant as described in Topic One,
except that the number of years of audited statements of operations is deter-
mined by the level of significance (Section D below). Refer to Section F
regarding age of financial statements.

**Exceptions:** Segment information under FAS 131 and
employers' disclosures about pensions and other postretirement
benefits are not required for nonpublic acquired businesses. [FAS
131, par. 9; FAS 132, par. 8] Earnings per share under FAS 128
is not required for acquired businesses that do not have publicly
held common stock or potential common stock. [FAS 128, par. 1]

b) Acquisition of **selected parts of an entity** may result in less than full
financial statements.

(1) In some circumstances, a registrant does not acquire or succeed to all of
the assets and liabilities of another entity. If the registrant acquires or
succeeds to substantially all of the entity's key operating assets, complete
audited financial statements of the other entity usually will be required.
Elimination of specified assets and liabilities not acquired or assumed by
the registrant is depicted in pro forma financial statements presenting the
effects of the acquisition. Full audited financial statements of the entity
are presumed to be necessary in order to provide investors with the
complete and comprehensive financial history of the acquired business.

(2) In other circumstances, the selling entity will retain significant operating
assets, or significant operating assets that comprised the seller will
continue to be operated by an entity other than the registrant. Financial
statements of the larger entity of which the acquired business was a part
may be misleading or uninformative. In that case, audited financial
statements usually should be presented for the acquired component
business, excluding the continuing operations retained by the larger
entity.
The staff may accept audited statements of assets acquired and liabilities assumed and statements of revenues and direct expenses if it is impracticable to prepare the full financial statements required by Regulation S-X, and explanation of that impracticability is included in the filing.

(a) The staff would expect the statement of revenues and direct expenses to exclude only those costs not directly involved in the revenue producing activity, such as corporate overhead, interest and taxes. Selling, general and administrative costs directly associated with producing revenues reflected in the statement must be included.

**NOTE:** If the registrant can’t identify or associate all costs necessary for the production, marketing and distribution of products with an acquired product line, it may indicate that the acquisition is not a business as defined in Article 11. Refer to I.C for the definition of a business.

(b) The statement should include a reasonable allocation of expenses incurred by the seller on behalf of the business sold. The reasons for omitting any historical corporate overhead, interest, or tax expense should be explained in a note to the statements. If the type and historical amounts of these omitted expenses are known or reasonably available on an unaudited basis, they should be disclosed in an unaudited footnote. [SP]

(4) When “carve-out” financial statements or statements of revenues and direct expenses are presented instead of full financial statements, full statements of cash flows are generally not required. However, registrants are required to provide information about the business’ operating, investing and financing cash flows, to the extent practicable, in the notes to the financial statements or in unaudited supplemental disclosures. [SP]

(5) Accompanying pro forma financial statements should include adjustments, if factually supportable, for excluded items as if the business had been acquired at the beginning of the periods presented. Refer to pro forma requirements and forward looking disclosures in Topic Three.

(6) Requests for substitution of abbreviated financial information in lieu of full financial statements should be directed to DCAO prior to filing.

c) **Supplemental schedules** (SX Article 12) are not required to be furnished. However, it may be necessary to include in footnotes to the financial statements, or elsewhere in a filing, certain information that ordinarily is furnished in the schedules and that is material to an understanding of the financial statements.
d) "Purchase" includes acquisition of an interest in a business that is accounted for under the equity method. Refer to Section C regarding definition of a "business".

e) 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)]

4. Exceptions to SX 3-05 financial statement requirements:

a) Pooling

Financial statements are not required in a registration statement if the acquisition was accounted for as a pooling-of-interests and is presently reflected in the registrant's restated audited financial statements. However, a reporting company with a significant pooling late in its fiscal year must still file the acquired company’s financial statements on Form 8-K even if the registrant’s Form 10-K is filed prior to the due date of the Form 8-K and includes financial statements restated for the pooling.

b) Audited annual balance sheet of registrant is of a date after consummation of the acquisition

Balance sheet of the acquired company is not required.

c) Acquiree financial statements have been previously filed

If the acquired operations are included in at least nine months of audited results, financial statements are not required unless the acquisition is of major significance. Although the acquisition may be of major significance at lower thresholds due to factors specific to the registrant, the staff presumes that the acquisition is of such major significance that investors need previously furnished financial statements of the acquired company in the registration statements if:

(1) the acquired business is included in audited results of the registrant for less than 9 months and was significant at the 50% or greater level; or
(2) It is included in audited results of the registrant for less than 21 months and was significant at the 70% or greater level. [SP]

d) Hostile tenders

Modified registration statement requirements may apply to some registration statements covering hostile tender offers to shareholders of a company that will not provide its financial statements. However, if the target of the tender offer is a public company, financial statements of the target that are in the public domain (filed with the Commission) may be incorporated by reference. A consent of the auditor may be required. The staff should consult with OMA and DCAO on these matters. [SAB 1A] See Section VI.A.4 of Topic Four for additional guidance regarding audit report and consent requirements in this situation.

e) Troubled financial institutions

If a financial institution is acquired in a federally assisted transaction and constitutes a business having material continuity of operations, the staff will not object to the omission of audited financial statements required by SX 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. Requests for waivers should be directed to DCAO. Additional disclosures are required when waivers are granted. [SAB 1K]

f) Foreign target

If the target is a foreign business, the financial statements need only comply with Item 17 of Form 20-F and are subject to the updating requirements under Item 8 of revised Form 20-F. If the foreign target is a non-reporting company and its financial statements are prepared on the basis of a comprehensive body of accounting principles other than U.S. GAAP, a reconciliation to U.S. GAAP in accordance
with Item 17 of Form 20-F is required unless a reconciliation is unavailable or not obtainable without unreasonable cost or expense. If a reconciliation is not available, the filing (continued next page) should contain, at a minimum, a narrative description of all material variations in accounting principles, practices, and methods used in preparing the non-U.S. GAAP financial statements from those accepted in the U.S. This guidance also applies to SB filers. The staff should consult with DCAO in instances where the U.S. GAAP reconciliation has been omitted on the basis of unavailability or unreasonable cost. Reconciliation requirements are described at Topic Six.

5. If a registrant is unable to provide the required financial statements of the acquired business, a request for a no action position by the Division's staff may be directed to DCAO (see below).

The staff generally will not waive the requirements of Form 8-K. However, in cases involving undue cost or difficulty, the staff usually will not recommend any action against the registrant which is based solely on failure to file the audited historical financial statements and pro forma financial information required by the form. If the financial statements and pro forma financial information required by Form 8-K are not filed within the extended time period provided by the form, the filing will be considered substantially deficient and, therefore, not filed in a timely manner for purposes of Forms S-2 and S-3 eligibility.

Further, until the registrant has filed audited financial statements reporting on the operations of the acquired business for a time span equal to the periods for which audited financial statements are required by SX 3-05 and the pro forma financial information required by SX Article 11, registration statements under the Securities Act of 1933 and post-effective amendments to registration statements may not be declared effective. In addition, registrants should not make offerings pursuant to effective registration statements, or pursuant to Rules 505 and 506 of Regulation D, where any purchasers are not accredited investors under Rule 501(a) of that Regulation, until the required audited financial statements are filed.

The foregoing '33 Act restrictions usually do not apply to (a) offerings or sales of securities upon the conversion of outstanding convertible securities or upon the exercise of outstanding warrants or rights; (b) dividend or interest reinvestment plans; (c) employee benefit plans; (d) transactions involving secondary offerings
by parties unrelated to the acquired business for which financial statements are not provided; or (e) sales of securities pursuant to Rule 144.

Once the registrant has filed audited financial statements that include the post-acquisition results of operations of the acquired entity for at least one year, the Division, at the request of the registrant, will consider a request to accept audited financial statements for a period of time less than that required by SX 3-05. At a minimum, the staff would expect audited pre- and post-acquisition financial statements for the acquired entity to equal the periods required under SX 3-05.

B. **Financial Statements of Target Companies in Form S-4**

1. Required financial statements: Form S-4 registers securities being offered to security holders of a business to be acquired. The requirement to include the financial statements of the target varies based on a number of facts and circumstances, as summarized below:

2. If the **target is a reporting company** (whether or not the issuer’s shareholders are voting), or the **target is a non-reporting company** and the **issuer’s shareholders are voting**, the registration statement must include:

   - balance sheets as of the two most recent fiscal years (or, for a target registrant reporting under S-B rules or a non-reporting target who would be S-B eligible, the latest fiscal year),

   - statements of income and cash flows for each of the three most recent fiscal years (two most recent fiscal years for a target registrant reporting under S-B rules or a non-reporting target who would be S-B eligible), and

   - interim information as recent as would have been filed on Form 10-Q had the target company been subject to the Exchange Act, except that interim information need include only cumulative year-to-date interim information of the target for the latest and comparable interim period. See Section I.F for target updating requirements.

**NOTE:** Targets of non-S-B registrants who are S-B eligible but are not current S-B reporting companies may apply S-B reporting requirements in the Form S-4 but must comply with S-X reporting requirements in a subsequent Form 8-K reporting the business combination.
3. If the target is a non-reporting company and the issuer’s shareholders are not voting:

<table>
<thead>
<tr>
<th>Significance of target under SX 3-05 or SB 310(c) does not exceed 20%</th>
<th>No target financial statements required in the registration statement, subject to the following: Registrants continue to have the obligation under SX 3-05 to evaluate the individually insignificant acquisitions in the aggregate, including the insignificant target. If, in the aggregate, the 50% significance level is reached, the registrant must present audited GAAP financial statements for a mathematical majority of those acquisitions for the most recently completed fiscal year and interim period.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Significance of target under SX 3-05 or SB 310(c) exceeds 20% level</td>
<td>GAAP financial statements for the most recently completed fiscal year and interim period are required in the registration statement. Prior years’ financial statements are also required if its financial statements prepared under GAAP were previously furnished to its security holders.</td>
</tr>
</tbody>
</table>

4. Pro forma financial information depicting the acquisition is only required if the acquisition is significant under SX 3-05 or SB 310 individually or in the aggregate.

5. Audit requirement: The requirement to audit depends on whether or not the Form S-4 is to be used for resales by persons considered underwriters under Rule 415.

<table>
<thead>
<tr>
<th>S-4 to be used for resales</th>
<th>S-4 not to be used for resales</th>
</tr>
</thead>
<tbody>
<tr>
<td>Audit is required for the periods required to be audited pursuant to SX 3-05. If audited financial statements for the periods required by SX 3-05 are not provided, the staff should obtain representation from registrant's counsel that the Form S-4 will not be used for resales by underwriters.</td>
<td>Only the latest year must be audited if: (a) the target is not subject to Section 13 or 15(d) of Exchange Act, or is a bank with a 12(i) exemption, and (b) the two years preceding the latest full fiscal year previously have not been audited. No audit will be required if impracticable.</td>
</tr>
</tbody>
</table>

To determine whether an audit is practicable, weigh the feasibility and expense of the audit against the usefulness of the audit to the target company's security holders. If the target is not closely held by insiders, the staff ordinarily will require audit of the most recent year's financial statements because shareholders may more
confidently base their decisions on financial data that has been attested to by independent auditors.*

* Although relief from obtaining audit of financial statements may be available as described above, the registrant would still be required to furnish all financial statements specified by Item 17 of Form S-4 on an unaudited basis.

NOTE: Relief from the audit requirement for financial statements of an acquired entity applies only to merger proxies and transactions registered on Form S-4 and is not applicable to other forms. If the acquisition is significant, audited financial statements will ordinarily be required in a Form 8-K after consummation.

C. Determination of a Business

What is a business?

1. A separate entity, subsidiary, division or possibly a separate product line

   a) A "business" for purposes of Rule 3-05 is 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. There is a presumption that a separate entity, subsidiary, or division is a business.

   b) A lesser component, such as a product line, also may be considered a business. In evaluating whether a lesser component is a business, you should consider the following:

      • Will the nature of the revenue producing activity generally remain the same?

      • Will the facilities, employee base, distribution system, sales force, customer base, operating rights, production techniques, or trade names remain after the acquisition? [SX 11-01(d)]

NOTE: The staff's analysis of whether an acquisition constitutes the acquisition of a business, rather than of assets, focuses primarily on whether the nature of the revenue producing activity previously associated with the acquired assets will remain generally the same after the acquisition. New carrying values of assets, or changes in financing, management, operating procedures, or other aspects of the business are not unusual following a business acquisition. Such changes typically do not eliminate the relevance of historical financial statements. Registrants that have succeeded to a revenue producing activity by merger or acquisition, with at least one of the other factors listed above remaining after the acquisition, should be encouraged to obtain concurrence from the staff in advance of a filing if they intend to omit financial statements related to the assets and activity.
Registrants may direct requests for interpretative letters related to appropriate financial statements of an acquired entity or group of assets to DCAO.

2. An investment accounted for under the equity method

3. A working interest in an oil and gas property

Audited statements of revenues and direct expenses are required, along with footnote disclosures of reserve quantities and the standardized measure pursuant to FAS 69. If the required FAS 69 information is not provided in filings on Form 8-K or other ‘34 Act filings within 75 days of the acquisition, that Form 8-K will not be considered to be filed timely and in certain circumstances may limit the registrant's ability to use Forms S-2 and S-3. [SP and SAB 2D]

4. Bank branch and insurance policy acquisitions
   a) The assumption of customer deposits at bank branches may constitute the acquisition of a business if historical revenue producing activity is reasonably traceable to the management or customer and deposit base of the acquired branches, and that activity will remain generally the same following the acquisition.
   b) Acquisitions of blocks of insurance policies by an insurance company or the assumption of policy liabilities in reinsurance transactions may also be deemed the acquisition of a business because the right to receive future premiums generally indicates continuity of historical revenues. The degree of continuity between historical investment income streams and the assets acquired to fund the acquired policy liabilities should also be considered.

D. Measuring Significance

1. How do I measure significance?
   a) The basic tests of significance are:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Compare registrant’s share of acquired entity’s total assets to the registrant’s consolidated assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment</td>
<td>If <strong>purchase accounting</strong>, compare total GAAP purchase price of acquired entity to registrant’s consolidated assets</td>
</tr>
<tr>
<td></td>
<td>• “Investment” means total consideration, including any assumed debt for which the registrant is the legal obligor, and costs of acquisition that will be allocated to assets and liabilities acquired</td>
</tr>
<tr>
<td></td>
<td>• Include contingent consideration as part of the total investment in the acquiree unless the likelihood of its payment is remote. [SP]</td>
</tr>
<tr>
<td></td>
<td>If <strong>pooling or reorganization</strong>:</td>
</tr>
</tbody>
</table>
• compare the net book value of the acquired entity’s assets 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

<table>
<thead>
<tr>
<th>Income</th>
<th>Compare registrant’s equity in the acquired entity's income from continuing operations before taxes, extraordinary items and cumulative effect of a change in accounting principle to that of the registrant</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• 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 a value of zero in computing the numerator for this average, but the denominator should be &quot;5&quot;.</td>
</tr>
<tr>
<td></td>
<td>• This rule is not applicable if the registrant reported a loss, rather than income, in the latest fiscal year.</td>
</tr>
<tr>
<td></td>
<td>• The acquiree's income may not be averaged pursuant to this rule.</td>
</tr>
</tbody>
</table>

b) The acquired business is not considered part of the registrant's base in determining significance. [S-X 1-02(w)]

c) 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.

d) Acquisitions of "related businesses" must be treated as a single business acquisition. Businesses are related under Rule 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.

e) Other guidance:

1) Step acquisitions.

• If a registrant increases its investment in a business relative to the prior year, base the tests of significance on the increase in the registrant's proportionate interest in assets and net income during the year, rather than the cumulative interest to date. However, step acquisitions which are part of a single plan to be completed within a twelve month period should be aggregated.

• When a registrant increases its investment in a company that is already consolidated, financial statements of the acquired
investment are ordinarily not required. However, pro forma information may be required.

(2) Evaluate significance using amounts determined on the basis of U.S. GAAP, rather than the foreign GAAP of the acquirer or acquiree.

(3) **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.

(4) Registrant's assets may not be increased for purposes of the significance tests by including the pro forma effect of **public offering proceeds** received after the balance sheet date.

2. Periods required

<table>
<thead>
<tr>
<th>If the Greatest of the Three Calculations in D.1.a above</th>
<th>Regulation S-X</th>
<th>Regulation S-B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Does not exceed 20%</td>
<td>No financial statements required</td>
<td>No financial statements required</td>
</tr>
<tr>
<td>Exceeds 20% but not 40%</td>
<td>Financial statements for the most recent fiscal year and the latest interim period preceding the acquisition, and the corresponding interim period of the preceding year</td>
<td>Financial statements for the most recent fiscal year and the latest interim period preceding acquisition, and the corresponding interim period of the preceding year</td>
</tr>
<tr>
<td>Exceeds 40% but not 50%</td>
<td>Financial statements for the two most recent fiscal years and the latest interim period preceding acquisition, and the corresponding interim period of the preceding year</td>
<td>Financial statements for the two most recent fiscal years and the latest interim period preceding acquisition, and the corresponding interim period of the preceding year</td>
</tr>
</tbody>
</table>
If the Greatest of the Three Calculations in D.1.a above Exceeds 50%  

<table>
<thead>
<tr>
<th>Regulation S-X</th>
<th>Regulation S-B</th>
</tr>
</thead>
</table>
| Financial statements for full three years and the latest interim period preceding acquisition, and the corresponding interim period of the preceding year  
  * Financial statements for the earliest of the three fiscal years may be omitted if net revenues of the acquired business in its most recent fiscal year are less than $25 million | Financial statements for the two most recent fiscal years and the latest interim period preceding acquisition, and the corresponding interim period of the preceding year |
3. Use the following financial statements to measure significance under SX 3-05:

a) General Rule

Compare the most recent pre-acquisition audited annual statements of the acquired business to registrant's pre-acquisition consolidated statements as of the end of the most recently completed audited fiscal year filed with the Commission.

b) If the acquisition is made after registrant’s most recent fiscal year end and Form 10-K is filed before due date of Form 8-K (i.e., within 75 days of acquisition):

⇒ may evaluate significance using registrant’s financial statements for most recent fiscal year reported in Form 10-K

c) If the acquisition is made after reporting a previous significant acquisition or disposition on Form 8-K or non-IPO registration statement that includes all information required by Form 8-K (see Section D.4 below for discussion of acquisitions pre- and post-IPO):

⇒ may evaluate significance using registrant pro forma financial information rather than historical pre-acquisition financial statements

For purposes of evaluating significance in this situation:

- compare income from continuing operation before income taxes, extraordinary items and cumulative effect of a change in accounting principle for the acquired entity's latest fiscal year to the pro forma income statement for the latest audited annual period provided in the Form 8-K or registration statement

- For the investment and asset tests, compare the registrant's investment in the acquired entity and the assets of the acquired entity for the latest fiscal year to the pro forma balance sheet comprising the latest audited balance sheet of the registrant. That pro forma balance sheet may or may not have been included in the Form 8-K or registration statement, depending on when the Form 8-K or registration statement was filed.

For example: If a calendar year end registrant filed a registration statement containing a pro forma balance sheet as of June 30, 1999 giving effect to an acquisition consummated on September 15, 1999 and then made an acquisition on
November 30, 1999, the asset and investment test would be based on a pro forma balance sheet as of December 31, 1998 (the last audited balance sheet on file with the Commission).

NOTE: Do not use the pro forma interim period balance sheet to determine significance unless the interim periods of the registrant are audited. To compute significance using pro forma information, only include those pro forma adjustments directly attributable to the transaction (e.g. purchase price allocation, depreciation, and amortization) in the pro forma income statement and balance sheet. If the registrant chooses to compute significance using pro forma information, it must do so for all three significance tests.

d) If a registrant or the acquiree has been in existence for less than one year:  
⇒ do not annualize historical financial statements.

e) If an acquisition is made after a transaction accounted for as a reverse acquisition of the registrant but before the audited financial statements for the fiscal year in which the reverse acquisition occurred are filed and the audited financial statements for the accounting acquirer have been filed with the SEC:  
⇒ measure significance against the accounting acquirer’s financial statements.

f) If an acquisition is made subsequent to the purchase by a shell registrant (or registrant with minimal operating activity) of an entity deemed the registrant’s predecessor (but not accounted for as a reverse acquisition or recapitalization):
⇒ measure significance against the historical financial statements of the registrant.

g) If an exchange transaction in which the registrant and another party each contribute businesses to a joint venture (or the “Newco”) in exchange for an equity interest in the Newco:
⇒ measure the significance of the disposition (registrant’s contributed business) and the acquisition (other party’s contributed business) separately to determine whether pro forma information about the disposition and receipt of an equity investment is required, and whether audited financial statements of the business contributed by the other party are required.

Significance of the acquisition should be based on the acquired percentage of the other party’s business compared to the registrant’s historical financial statements (without adjustment for the related disposition of the business contributed by the registrant.
to the joint venture). Whether or not the transaction is accounted for at fair value, the investment test should be based on the fair value of the consideration given up or the consideration received, whichever is more reliably determinable.

If reporting of both the disposition and the acquisition are required by Form 8-K, a registrant may be unable to present a pro forma income statement depicting the joint venture formation because financial statements of the business contributed by the other party are not available. Those financial statements and related pro forma financial statements need not be filed until 75 days after the transaction is consummated. Pro forma financial statements depicting a significant disposition are required to be filed within 15 business days of the disposition. In these circumstances, the initial Form 8-K reporting the transaction should include a narrative description of the effects of the disposition, quantified to the extent practicable, with complete pro forma information depicting the effects of the exchange of interests furnished at the time that the audited financial statements of the acquired business are filed.

4. Special Significance Tests for Initial Public Offerings (IPO’s)

a) Staff Accounting Bulletin 80 (SAB 80 or Topic 1J)

SX 3-05 and SB 310 identify the financial statements of businesses recently acquired or likely to be acquired that must be included in a registration statement. In some cases involving IPOs, strict application of the rule is problematic or results in provision of financial statements that are clearly not material.

Registrants preparing an IPO may consider applying SAB 80. SAB 80 is an interpretation of SX 3-05 for application in the case of IPO’s 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 includes:

- at least three years of audited financial statements of at least 60% of the constituent businesses that will comprise the registrant on an ongoing basis, and
- at least two years of audited financial statements of at least 80% of the constituent businesses that will comprise the registrant on an ongoing basis, and
- at least one year of audited financial statements of at least 90% of the constituent businesses that will comprise the registrant on an ongoing basis.

**NOTE:** These percentages have not changed even after adoption of SX 3-05 significance revisions and SB reporting rules.
The SAB permits initial registrants to consider the significance of recently acquired and to be acquired companies based on pro forma financial statements for the registrant's most recently completed fiscal year. The **pro forma data** assume all businesses to have been acquired at the beginning of that fiscal year (for income tests) and at the end of the fiscal year (for asset and investment tests).

To measure significance apply the asset and investment tests to a pro forma balance sheet as of the latest audited balance sheet included in the registration statement. Apply the earnings test to the registrants most recent audited fiscal year included in the registration statement.

For:

| Businesses not included for at least 9 months in the registrant’s financial statements: | May exclude pre-acquisition financial statements to the extent that the sum of their highest significance levels is less than 10% |
| Businesses not included for at least 21 months in the registrant’s financial statements: | May exclude pre-acquisition financial statements to the extent that the sum of their highest significance levels is less than 20% |
| Businesses not included for at least 33 months in the registrant’s financial statements: | May exclude pre-acquisition financial statements to the extent that the sum of their highest significance levels is less than 40% |

Audited financial statements required to be furnished to satisfy the requirements of the SAB should be for continuous periods, with no gap or overlap between pre-acquisition and post-acquisition periods.

b) Tests of significance after an IPO in which SAB 80 was applied.

(1) If the provisions of SAB 80 were used in an IPO to obtain relief from the reporting requirements of SX 3-05, the staff would allow that registrant to evaluate the significance of post-IPO acquisitions using the pro forma financial statements presented in the IPO. However, those pro forma financial statements should be adjusted to eliminate:

- pro forma effects of acquisitions for which no audited financial statements are presented in the IPO,
- the pro forma effects of acquisitions that were probable at the time the IPO was declared effective but which have yet to be consummated, and
pro forma adjustments not directly attributable to the acquisitions.

Once the registrant files audited annual financial statements (either in a Securities Act or Exchange Act filing) for the fiscal year following the audited fiscal year presented in the IPO registration statement on which pro forma financial statements were based, the registrant should measure significance of acquisitions using the audited financial statements of the registrant as required by SX 3-05. Upon written request, the staff will consider whether relief from the literal application of SX 3-05 is appropriate.

(2) Financial statements of a business acquired subsequent to an IPO may also be required in a registration statement if the significance of that acquisition, plus other acquisition entities for which no audited financial statements were provided in the IPO prospectus, aggregate 50% or more of adjusted pro forma IPO financial statements. See Section E below.

c) SAB 97 “put-together” transactions

In transactions in which more than two entities combine concurrent with an IPO, measure significance against the accounting acquirer (regardless of whether or not the accounting acquirer is a Newco). All of the acquired businesses are considered related under SX 3-05(a)(3) and SB 310(c)(ii) and therefore must be grouped and assessed for significance against the accounting acquirer as a single acquisition (see Section I.D.1.d). SAB 80 may not be applied to individual entities within the group. SAB 80 may only be applied to acquisitions that are not considered related, such as previous acquisitions made by the accounting acquirer if that entity was built through a series of unrelated acquisitions. Upon written request, the staff will consider whether relief from the literal application of SX 3-05 is appropriate.

d) Tests of significance after a put-together IPO

(1) If a new acquisition takes place after an IPO but before the filing of the registrant’s first Form 10-K, measure significance against the audited financial statements of the accounting acquirer for the most recent fiscal year (that was included in the IPO registration statement).

(2) If a new acquisition takes place after the filing of the registrant’s first Form 10-K, measure significance against the audited financial statements of the registrant for the most recent fiscal year in the Form 10-K. In some cases, such as when the IPO occurs close to the registrant’s year end, the registrant’s financial statements presented in Form 10-K may only include operations for a very short period of time. Upon written request, and depending on the proximity of the SAB 97 transaction to the balance sheet date, the staff will consider whether relief from the literal application of SX 3-05 is appropriate.
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.

E. Individually Insignificant Acquirees

The requirement under SX 3-05 to furnish financial statements of individually insignificant businesses under certain circumstances is applicable only to registration statements and proxies. Form 8-K does not require audited financial statements of insignificant acquirees unless they are "related businesses" (see Section I.D.1.d above).

1. If the aggregate of all insignificant businesses (consummated since the latest audited year-end balance sheet filed and probable, including significant businesses for which financial statements are not yet required because of the 75-day rule) exceed 50% in any condition in I.D.1 above, financial statements for the mathematical majority (combined if appropriate) should be furnished for the most recent fiscal year and the latest interim period preceding the acquisition. For purposes of determining the mathematical majority, audited financial statements should be provided for those acquired entities that constitute more than 50% of the asset, income, or investment test determined to be the most significant.

For example: A registrant with a calendar year end files a registration statement October 1, 1999. The following individually insignificant business acquisitions, for which no audited financial statements were filed on Form 8-K, have occurred since the registrant’s audited financial statements were filed in its 1998 Form 10-K:

<table>
<thead>
<tr>
<th>Date Acquired</th>
<th>Investment Test %</th>
<th>Asset Test %</th>
<th>Income Test %</th>
<th>Highest Significance %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business A</td>
<td>1/21/99</td>
<td>10</td>
<td>19</td>
<td>8</td>
</tr>
<tr>
<td>Business B</td>
<td>2/24/99</td>
<td>10</td>
<td>7</td>
<td>6</td>
</tr>
<tr>
<td>Business C</td>
<td>4/11/99</td>
<td>11</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>Business D</td>
<td>7/6/99</td>
<td>13</td>
<td>11</td>
<td>5</td>
</tr>
<tr>
<td>Business E</td>
<td>8/20/99</td>
<td>17</td>
<td>10</td>
<td>20</td>
</tr>
<tr>
<td>Probable F</td>
<td>N/A</td>
<td>9</td>
<td>6</td>
<td>4</td>
</tr>
<tr>
<td>Aggregate</td>
<td></td>
<td>70</td>
<td>58</td>
<td>49</td>
</tr>
</tbody>
</table>

Since the investment test yields the greatest significance on an aggregate basis (70%), financial statements of the “businesses” adding up to at least 35% under the investment test column must be provided. In this case, financial statements for any combination of three “businesses” that includes Business E or any combination of four “businesses” would meet the requirement. No combination of three that excludes Business E would meet the requirement.

Note: As shown above, even though the registrant is not required to file a Form 8-K with audited financial statements of Business E until 11/2/99,
those financial statements may need to be included in the registration statement.

2. Losses of businesses reporting losses should not be offset against income of businesses reporting income for purpose of income test; the two groups should be evaluated separately. The absolute values of the results of operations of the two groups would not be aggregated for purposes of applying the significance tests. However, the absolute values of the results of operations of the two groups would be aggregated for purposes of selecting the mathematical majority.

3. In a registration statement or proxy which is made effective or mailed after fiscal year end but prior to the date audited year-end statements are required, individually insignificant acquisitions acquired since the previous year-end through the date of effectiveness should be aggregated for purposes of this test.

4. SX 3-05 permits a registrant to evaluate significance of acquirees using the pro forma financial information filed on Form 8-K in connection with a previous significant acquisition. However, a registrant may not circumvent the requirement to furnish audited data of a majority of individually insignificant acquirees by filing a Form 8-K containing financial statements of one or more insignificant acquirees and testing significance of the remaining unaudited acquirees, against either the historical or resulting pro forma financial statements. If a registrant has filed a Form 8-K for a previous significant acquisition, the 50% aggregation test may be applied against the pro forma financial statements included in that Form 8-K.

*For example:* A registrant files a registration statement on July 15, 1999 that includes audited financial statements for the year ended December 31, 1998 and interim period statements for the three months ended March 31, 1998. The registrant had total assets of $1000 at December 31, 1998 and reported income from continuing operations before taxes of $100 for the year then ended. The registrant had, or expects to have, the following acquisitions since December 31, 1998:

<table>
<thead>
<tr>
<th>Date Acquired</th>
<th>Investment $</th>
<th>Assets $</th>
<th>Income $</th>
<th>Highest Significance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Significant acquisitions:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Business A</td>
<td>4/8/99</td>
<td>210</td>
<td>100</td>
<td>30</td>
</tr>
<tr>
<td>Insignificant acquisitions:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Business B</td>
<td>2/3/99</td>
<td>40</td>
<td>20</td>
<td>9</td>
</tr>
<tr>
<td>Business C</td>
<td>3/16/99</td>
<td>60</td>
<td>40</td>
<td>13</td>
</tr>
<tr>
<td>Business D</td>
<td>6/14/99</td>
<td>160</td>
<td>80</td>
<td>16</td>
</tr>
<tr>
<td>Business E</td>
<td>7/1/99</td>
<td>50</td>
<td>20</td>
<td>11</td>
</tr>
<tr>
<td>Probable F</td>
<td>N/A</td>
<td>200</td>
<td>100</td>
<td>18</td>
</tr>
</tbody>
</table>
In this example, audited financial statements and pro forma financial information were filed on Form 8-K for Target A on 6/15/99. The pro forma financial information reflects purchase accounting as follows:

<table>
<thead>
<tr>
<th></th>
<th>Assets</th>
<th>Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Registrant historical</td>
<td>$1000</td>
<td>$100</td>
</tr>
<tr>
<td>Adjustments</td>
<td>210</td>
<td>25</td>
</tr>
<tr>
<td><strong>Pro forma</strong></td>
<td><strong>$1210</strong></td>
<td><strong>$125</strong></td>
</tr>
</tbody>
</table>

Aggregate significance may be calculated using pro forma asset and income information for the year ended December 31, 1998 depicting acquisition of Target A. In this case, the income test yields the highest aggregate significance test (52%). The registration statement must include financial statements for acquired businesses that total to at least $34 ($67 x 51%) to meet the SX 3-05 requirement. Had the aggregate significance under each test been less than 50% using pro forma information, no financial statements for any of the individual entities would be required in the registration statement. Note that, since the pro forma amounts were used to calculate significance, no financial statements for Probable F will be required on Form 8-K when that acquisition is consummated.

F. Age of Financial Statements of Companies Acquired or To Be Acquired

1. For year end financial statements in a '33 Act registration statement:

<table>
<thead>
<tr>
<th>Effective date of Filing</th>
<th>Acquiree Financial Statements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Filing is made effective after 89th day after acquiree’s fiscal year end</td>
<td>Acquiree’s most recent fiscal year must be audited</td>
</tr>
<tr>
<td>Registrant’s filing is made effective after 45 days but within 90 days of the acquiree’s fiscal year end</td>
<td>Updating requirement dependent on the registrant’s (not the acquiree’s) eligibility for relief under SX 3-01(c)</td>
</tr>
</tbody>
</table>

a) After a reverse acquisition, consider the accounting acquirer’s ability to meet the requirements of Rule 3-01(c) of Regulation S-X in determining the need to update.

b) In limited circumstances involving a registrant that would be required to update after the 45th day, applying this rule results in a requirement to furnish audited financial statements of the acquiree as of a date more recent than is required for the registrant. If the registrant believes providing updated audited financial statements would impose an unreasonable burden under the circumstances, the registrant may request DCAO to consider granting relief if the acquiree’s financial statements are updated on an unaudited basis through
either the registrant's latest balance sheet date or the acquiree's year-end. Requests for relief should be made in writing prior to filing.

For example: A registrant with a December 31, 1999 year end is required under SX 3-01(c) to update its audited financial statements after February 14, 2000 in a registration statement. The registrant is acquiring a business with a November 30, 1999 year end. If the registration statement is declared effective February 1, 2000, the registration statement would require audited financial statements of the registrant for the year ended December 31, 1998 and unaudited financial statements for the nine months ended September 30, 1999. Unless relief is obtained, the target’s audited financial statements would be required for the year ended November 30, 1999 since February 1 is beyond 45 days after target’s year end and the registrant is not eligible for relief under SX 3-01(c).

2. For interim period financial statements in a ‘33 Act registration statement, age requirements are the same as if the acquiree were the registrant (see Topic One, Section II).

   a) Generally, financial statements of an acquired business need not be updated if the omitted period is less than a complete quarter.

   For example: If an acquisition was consummated on September 29, the staff generally would not require that the financial statements of an acquired entity be updated past June 30. However, disclosure of significant events occurring during the omitted interim period may be necessary.

   b) Financial statements audited through the date of acquisition should be furnished for any business deemed a predecessor or whose significance was determined pursuant to SAB 80 if the registrant's financial statements for the year of the acquisition are required to be audited. The updating requirements of SX 3-05 should be followed in subsequent registration statements. No updating is required for ‘34 Act periodic reporting.

For example: A registrant with a December 31, 1998 year end has an IPO Form S-1 registration statement declared effective February 3, 1999. The registrant acquired several businesses during 1997 and 1998 and applied SAB 80 in determining the required financial statements for those businesses. Among those financial statements are the following for the most recent fiscal year and interim period:

<table>
<thead>
<tr>
<th>Entity</th>
<th>Fiscal Year End</th>
<th>Date Acquired</th>
<th>Audited Annual Financial Statements</th>
<th>Unaudited Interim Financial Statements</th>
<th>Audited Interim Financial Statements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Registrant</td>
<td>12/31</td>
<td>N/A</td>
<td>12/31/97</td>
<td>1/1/98 - 9/30/98</td>
<td>N/A</td>
</tr>
<tr>
<td>Target A</td>
<td>6/30</td>
<td>12/15/97</td>
<td>6/30/97</td>
<td>N/A</td>
<td>7/1/97 - 12/14/97</td>
</tr>
</tbody>
</table>
In a subsequent registration statement declared effective June 15, 1999, the following financial statements related to the same entities would be required for the most recent fiscal year and interim period:

<table>
<thead>
<tr>
<th>Registrant</th>
<th>Fiscal Year End</th>
<th>Date Acquired</th>
<th>Audited Annual Financial Statements</th>
<th>Unaudited Interim Financial Statements</th>
<th>Audited Interim Financial Statements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Registrant</td>
<td>12/31</td>
<td>N/A</td>
<td>12/31/98</td>
<td>1/1/99 - 3/31/99</td>
<td>N/A</td>
</tr>
<tr>
<td>Target A</td>
<td>6/30</td>
<td>12/15/97</td>
<td>6/30/97</td>
<td>N/A</td>
<td>7/1/97 - 12/14/97</td>
</tr>
<tr>
<td>Target B</td>
<td>12/31</td>
<td>3/1/98</td>
<td>12/31/97</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Target C</td>
<td>6/30</td>
<td>1/1/99</td>
<td>6/30/98</td>
<td>7/1/98 - 12/31/98</td>
<td>N/A</td>
</tr>
<tr>
<td>Target D</td>
<td>12/31</td>
<td>2/10/99</td>
<td>12/31/98</td>
<td>N/A</td>
<td>N/A</td>
</tr>
</tbody>
</table>

3. In a ’34 Act environment:

a) For purposes of proxy materials, the staff interprets the updating requirements in the same manner as under the ’33 Act.

b) Form 8-K

1. General. The staff believes that the age of financial statements in a Form 8-K should be determined by reference to the filing date of the Form 8-K initially reporting consummation of the acquisition. If no filing is made timely within 15 days of the acquisition, the age of financial statements required to be filed should be determined by reference to the 15th day after the consummation of the acquisition.

2. Year end. For purposes of Form 8-K, the staff would not require audited statements of the acquiree's most recently completed year unless the Form 8-K reporting the acquisition was filed 90 days or more after the acquired company's fiscal year-end.

3. Interim information. In some cases, the financial statements provided in Form 8-K may need to be updated in a registration statement to comply with the 135-day rule (see Topic One, II.B).

For example: A registrant files a Form 8-K reporting an acquisition which occurred on July 10. The registrant and the acquiree have calendar fiscal year ends. The Form 8-K includes the acquiree’s interim financial statements as of March 31. A registration statement filed in December of the same year will not be declared effective unless the acquiree’s financial statements are updated through at least June 30.

c) Previously furnished financial statements
(1) Financial statements of an acquiree are not required in Form 8-K if they were previously filed. [Form 8-K; Gen. Instruction B.3.] Financial statements of a significant acquired business previously furnished in a registration statement will be deemed "substantially the same" pursuant to this instruction unless they would not satisfy the required age of financial statements in the Form 8-K because operating results for two or more interim quarters are omitted.

For example: Form S-4 included unaudited financial statements for the three months ended March 31 for a business to be acquired. The business combination was consummated on October 1, and a Form 8-K reporting the acquisition was timely filed. No financial statements are required in the Form 8-K, unless there were significant subsequent events that would materially affect an investor's understanding of the target company. However, if the business combination had been consummated on November 20, the financial statements would have had to be updated through September 30.

NOTE: If a registrant included financial statements of a previously nonpublic SB eligible target in a Form S-4 and those financial statements complied with SB reporting requirements instead of SX reporting requirements (see Section I.B), those financial statements would not be deemed “substantially the same” pursuant to Form 8-K; Gen. Instruction B.3. Financial statements that comply with SX would need to be filed in a Form 8-K if the SX 3-05 significance threshold is met.

(2) If updating pursuant to rules usually applicable to the Form 8-K would require audited financial statements to be filed, the staff generally would conclude that the audited annual financial statements are not substantially the same as the previously filed unaudited interim financial statements. In those circumstances, updated audited financial statements should be furnished in the Form 8-K.

For example: Form S-4 contained unaudited financial statements of the entity to be acquired for the nine months ended September 30. Updated audited financial statements of the acquired entity are required in a Form 8-K if the business combination is consummated, and the Form 8-K is filed after the 89th day subsequent to December 31. Note that in a registration statement, updated audited financial statements of the acquired entity may be required before the 90th day, depending on the registrant's eligibility under Rule 3-01(c) of Regulation S-X. Refer to I.F.1 above regarding
the requirements to provide audited financial statements of an acquired entity.
4. Issues arising from ’33 and ’34 Act Integration

a) Acquiree financial statements and certain offerings

During the 75 day period for providing financial statements of acquirees in Form 8-K, registration statements will be declared effective even if financial statements of ≥50% significant acquirees are not provided only in the case of secondary offerings, securities underlying outstanding convertible securities or warrants or rights, and reinvestment and employee benefit plans. Prior to declaring these registration statements effective, however, the staff should consider the need to obtain assurance from the issuer that the required financial statements will be timely filed.

b) Forms S-2, S-3 and S-4

(1) **At effectiveness:** The registrant should comply with age-of-financial-statement rules with respect to itself and all completed and probable acquirees at the time of effectiveness. Any updated financial statements required to be included or incorporated by reference in the registration statement but which were not required to be furnished previously in a specific Exchange Act report may be furnished under cover of Form 8-K pursuant to Item 5.

*For example:* A registrant files a Form 8-K on August 13 reporting the acquisition of a business on July 31. That Form 8-K included unaudited financial statements for the 3 months ended March 31. If a registration statement is filed after August 13, the financial statements of the acquired entity must be updated through June 30 so that the acquired entity's financial statements meet the age of financial statement requirements of Regulation S-X. If the acquisition was consummated prior to June 30, updated financial statements would not be required.

If a Form 8-K reporting an acquisition was timely filed and the financial statements of the acquiree required by the Form were timely furnished, the **staff will consider a request to waive updating** of the acquiree's financial statements at effectiveness of a registration statement. For a waiver:

- the registrant must demonstrate that an update would involve unreasonable expense and effort, and
- the registration statement must include at least one complete quarter of post-acquisition operating results of the registrant.

The staff is unlikely to waive the requirements of the rule if audited financial statements would be required of an acquiree whose significance exceeds 40%.
(2) **Delayed and continuous offerings:** After effectiveness, the registrant has no specific obligation to update the prospectus except as stipulated by 33 Act Rule 10(a)(3) and with respect to any fundamental change. If an acquisition would be significant under Rule 3-05, the staff recommends that management consider whether the probability of consummation of the transaction would represent a fundamental change.

**What is a “fundamental change?”**

- It is the responsibility of management to determine what constitutes a fundamental change and it is based generally on whether additional information is necessary for an investor to make an informed investment decision. (Refer to Item 512(a) of Regulation S-K).

- The registrant should also consider whether individually insignificant acquisitions occurring subsequent to effectiveness, when combined with individually insignificant acquisitions that occurred after the most recent audited balance sheet in the registration statement but prior to effectiveness, may be of such significance in the aggregate that an amendment is necessary.

II. **Real Estate Acquisitions and Properties Securing Mortgages**

**A. Real Estate Operations [SX 3-14]**

1. Financial statement requirements for registration statements and proxies

   a) Financial statements of each operating real estate property (or group of related properties) acquired or probable of acquisition that is significant individually or in the aggregate at the 10% level or higher is required to be filed in all transactional filings (registration statements and proxies).

   **Note:** The purchase of real estate by companies engaged in real estate activities is not considered to be an acquisition in the ordinary course of business. Item 2 Form 8-Ks are required to report these transactions.

   b) SX 3-05 allows a repeat filer to omit from a registration statement financial statements for a business acquisition less than 50% significant if the registration statement is declared effective no more than 74 days after the date the acquisition is consummated. That provision does not apply to SX 3-14 financial statements.

   c) Individually Insignificant Acquirees

      (1) To compute significance, combine individually insignificant properties into two groups: (a) properties acquired during the most recently
completed fiscal year, and (b) properties acquired during the interim period and probable acquisitions. Compute significance for each group separately based on the registrant’s total assets as of the latest audited fiscal year balance sheet date preceding the acquisition.

(2) If the aggregate of all insignificant real estate properties in either group exceeds 10% of the registrant’s total assets, financial statements are required of operating real estate properties in the group(s) that exceed(s) the 10% level.

Generally, the staff will not object to the omission of audited financial statements of an individually insignificant property that is significant below the 5% level if:

- the property is acquired from an unrelated party, and

(b) audited financial statements of the majority (>50%) of all individually insignificant properties in the group are provided.

2. For ‘34 Act reporting purposes, financial statements of each operating real estate property (or group of related properties) acquired that is individually significant at the 10% level or higher is required to be filed in a Form 8-K.

3. Significance is computed by comparing the registrant's investment in the property to the registrant's total assets at the latest audited fiscal year end filed with the SEC (except as noted in (1) above). If the acquired property is encumbered with mortgage debt that will continue after the acquisition, include that debt as part of the investment in determining significance.

- If the company has not completed its first fiscal year, use the most recent audited balance sheet filed with the Commission.

- If the acquisition was made 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), the staff has not objected if significance is evaluated relative to the most recently completed fiscal year.

- While SX 3-05 permits the determination of significance to be made using pro forma financial information included in a Form 8-K reporting a significant acquisition, this determination of significance is not applicable to SX 3-14.

4. Additional Requirements for "Blind Pool" Offerings

Registration statements for "blind pool" offerings by real estate companies include undertakings to:
file a sticker supplement during the distribution period describing each property that has not been identified in the prospectus whenever a reasonable probability exists that a property will be acquired, and

consolidate all stickers in a post-effective amendment filed at least once every 3 months. The post effective amendment must include audited financial statements in the format described in SX 3-14 for all properties which have been acquired. Pro forma information is also required.

In addition to sticker supplements, companies are required to file a current report on Form 8-K that includes financial statements and the related pro forma information for each property acquired during the distribution period that exceeds 10% of the company’s total assets at the date the agreement is signed. These financial statements are not required if they are substantially the same as those previously filed. Refer to I.F.3.c.

The distribution period is the period during which partnership units are sold. While companies do not undertake to file sticker supplements after this period is completed, they undertake to file on Form 8-K audited financial statements of properties, in the format described in SX 3-14, after this period is completed. Specifically, companies undertake to file audited financial statements for every property it commits to purchase (by signing a binding purchase agreement) once the company commits to the use of 10% or more of the net proceeds of the offering. The staff has not objected to the view that the undertaking to provide audited financial statements is not applicable to individually immaterial properties. SX 3-14 financial statements may be omitted for individually immaterial properties.

An individual property is material if it:

(a) is acquired from a related party, or
(b) exceeds the 5% significance level, or
(c) is one of a group of properties that
   • together aggregate more than 5% and are acquired from a single seller, or
   • are related.

When are properties considered related?

Properties are related if their acquisitions are contingent on one another or are otherwise related to one another by virtue of location or other material financial or commercial factor.

Reporting companies must comply with the reporting requirements of Form 8-K for financial statements under Rule 3-14. Refer to II.A.2.
5. Required Financial Statements
   
a) Abbreviated income statements
      
      May exclude items (such as historical mortgage interest and depreciation) which are not comparable to the proposed future operations of the property. (Where items are excluded, auditors ordinarily will issue a report such as that at AU 621.14 and 623.15.)

b) Periods to be presented
      
      Audited three years (two years in the SB Forms), plus unaudited interim period based on the property’s fiscal periods. Only the most recent year and current interim period are required if the property was not acquired from a related party.

c) Other required disclosure
      
      The registrant should describe any material factors which would cause the reported financial information not to be indicative of future operating results. *For example:* A change in how the property will be used, an expected material modification to the property, or a material change in property tax assessment.

d) Application of SX 3-06
      
      SX 3-06 does not apply to financial statements of real estate properties. The staff, however, will not require a registrant to include the financial statements of an individually insignificant operating property acquired from an unrelated party in a transactional filing if the acquired operations have been included in the registrant’s audited operating results for at least nine months.

e) Updating requirements
      
      The same rules for updating 3-05 financial statements apply to 3-14 financial statements. See Section 1.F.

6. REIT Formation Transactions
   
a) Test of significance in an IPO
      
      A newly-formed REIT having no significant operations may acquire operating properties immediately prior to filing an initial registration statement, or may identify properties to be acquired upon closing the IPO. In addition, the REIT may identify properties that it will probably acquire soon after the IPO. The staff recognizes in these circumstances that the literal application of Rule 3-14 could result in the registrant providing financial statements of properties that are clearly immaterial to investors.
Financial statements of properties that are significant at the 10% level individually or in the aggregate with other individually insignificant properties must be filed in the REIT IPO. In identifying the financial statements required to be included in the initial registration statement, the staff has allowed registrants to compute significance using a base equal to the total cost of the properties acquired immediately prior to filing an initial registration statement, properties to be acquired upon closing the IPO, and properties identified as probable future acquisitions. Even though the staff has allowed registrants to use this base in the initial registration statement, they still need to include financial statements of individually insignificant properties if their aggregate cost exceeds 10% of the base. However, the financial statements of individually insignificant properties below the 5% level may be omitted if the property is acquired from an unrelated party and audited financial statements of the majority (>50%) of all individually insignificant properties acquired and to be acquired are provided.

NOTE: Remember to treat the acquisition of a group of related properties as a single acquisition in measuring significance. Properties are related if they are under common control or management, the acquisition of one property is conditional on the acquisition of each other property, or each acquisition is conditioned on a single common event.

b) Tests of significance after an IPO

In computing significance of any future property acquisition until the time the registrant files its initial Form 10-K, the registrant can use the same base as was used in the initial registration statement. However, that base should be reduced for any property not acquired unless audited financial statements were included in the registration statement and acquisition remains probable.

7. Application of SX 3-14 is limited to real estate operations.

The reduced financial statement requirements available to real estate operations are premised on the continuity and predictability of cash flows ordinarily associated with commercial and apartment property leasing, and generally includes shopping centers and malls. Nursing homes, hotels, motels, golf courses, auto dealerships, equipment rental operations and other businesses that are more susceptible to variations in costs and revenues over shorter periods due to market and managerial factors are not considered to be "real estate operations". Thus, SX 3-05, rather than SX 3-14 and the special undertaking in the industry guide, is applicable to those businesses.

Where a registrant acquires an equity interest in a partnership or corporation owning real estate properties, financial statements of that entity meeting the requirements of SX 3-05 would generally be required. The staff has not objected
to presenting SX 3-14 financial statements of the real estate properties in lieu of SX 3-05 financial statements where the entities have no operations other than holding real estate and related debt.

B. Properties Subject to Net Lease

If a real estate property will be leased to a single tenant on a long-term basis immediately after its acquisition under a net lease that transfers substantially all of the property's nonfinancial operating and holding costs to the tenant, financial data and other information about the tenant (or other party that guarantees the lease payments) may be more relevant to investors than financial statements of the property acquired. In that case, the financial statements of the property may be omitted from the filing, but pertinent financial data and other information about the lessee or guarantor should be furnished. That information should include audited financial statements of the lessee or guarantor if the purchase price of the property exceeds 20% of the greater of total assets at the latest audited year end balance sheet date or the amount expected in good faith to be raised within the next twelve months pursuant to an effective registration statement. That view is consistent with the guidance furnished in SAB 71 concerning significant credit concentrations. If the lessee or lease guarantor is a public company currently filing reports with the Commission, only summary data need be provided. The disclosure pertaining to a material lessee, including its audited financial statements if the investment exceeds 20% of total assets, should be provided in filings made under both the Securities Act and the Exchange Act. The periods presented for lessee or guarantor financial statements should comply with SX 3-01 and 3-02.

C. Properties securing Acquisition Development and Construction ("ADC") arrangements [SAB 11]

What is an “ADC arrangement?”

“ADC arrangement” is defined in 2/10/86 Notice to Practitioners in CPA Letter. In an ADC arrangement, a lender participates in expected residual profit and shares in the risk and rewards of the owner.

1. Financial Statement Requirements in '33 Act filings

a) Financial statements of operating properties securing ADC loans are required for any single property for which 10% of offering proceeds (or total assets at the latest audited year end balance sheet date, if greater) has been or will be loaned. The information required by Items 14 & 15 of Form S-11 also are required.

b) Where no single loan exceeds 10%, but the aggregate of ADC loans exceed 20%, a narrative description of the properties and arrangements is required in a note.
2. Financial Statement Requirements in ’34 Act filings
   a) If over 20% of total assets are invested in a single ADC loan, financial statements of the underlying operating property are required (except in Annual Reports to shareholders where only summary data is required).
   b) If over 10%, but less than 20%, is invested in a single ADC arrangement, summarized financial information of the operating property is required.
   c) Where individual loans are not significant but the aggregate exceeds 20%, narrative description of the properties and arrangements is required in a note.

D. Properties Securing Ordinary Loans

If over 20% of offering proceeds (or total assets at the latest audited year end balance sheet date, 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 both ’33 and ’34 Act filings. Properties are related, for example, if they are subject to cross default or collateralization agreements.

III. Financial Statements of Equity Investments Not Consolidated

[A. Required Separate Financial Statements]

1. Separate financial statements of non-consolidated subsidiaries. If any of the conditions set forth in SX 1-02(w) are significant at the 20 percent level or greater, separate financial statements for each subsidiary not consolidated should be provided. (Of course, consolidation is presumed to be necessary for all subsidiaries.)

2. Separate financial statements of equity investments accounted for under the equity method of accounting. If either the income or investment conditions set forth in SX 1-02(w) are significant at the 20 percent level or greater, separate financial statements for each significant 50% or less owned equity investment not consolidated should be filed. The asset test does not apply.

3. The financial statements required should be for the same annual audited periods as required by SX 3-01 and 3-02. Separate audited financial statements for equity method investments are required for those periods where the income or the investment test in SX 1-02(w) equal or exceed 20 percent. Other periods presented may be unaudited. For example, if an equity method investment was 30% significant in 1998 and 19% significant in 1999, audited financial statements of the investee are required for 1998 and unaudited financial statements are permitted for 1999.
4. Audited or unaudited SX 3-09 financial statements are not required for **periods prior to the registrant’s ownership of the investment** but they may be required under SX 3-05 in the year of acquisition.

5. If a registrant’s **financial statements are retroactively restated** in accordance with APB 18.19 to reflect equity method accounting for an investment previously accounted for under the cost method, 3-09 financial statements, and summarized financial information required by SX 4-08(g), may be required for periods in which the cost method was previously used if the significance tests are met.

6. **Lower tier 3-09 financial statements.** To determine whether separate financial statements of an investee accounted for by the equity method by an investee of a registrant are required, the significance test should be computed based on the materiality of the lower tier investee to the registrant consolidated. [SAB 6K.4]

7. If the fiscal year of the non-consolidated entity ends within 90 days before the filing of the registrant's Form 10-K, or ends after the date of filing the registrant's Form 10-K, the financial statements required by SX 3-09 may be filed in an amendment to the Form 10-K within 90 days (for domestic issuers) or six months (for foreign private issuers) after the subsidiary's fiscal year end. [3-09(b)]

**B. Measuring Significance**

1. If the tested equity investee incurred a loss and if income averaging is used by the registrant (because income in the most recent fiscal year is at least 10 percent lower than the average of the income for the last five fiscal years), the equity in the income or loss of the investee should be excluded by the registrant from each year averaged.

2. For purposes of computing the income significance test under SX 3-09, use GAAP changes in the equity investment as presented in the income statement, which usually includes amortization of goodwill resulting from the registrant's equity investment and any writedown of the investment for impairment that is not otherwise reflected in the investee’s financial statements.

**C. Combined / Consolidated Financial Statements of Unconsolidated Subsidiaries.**

SX 3-09 allows for the presentation of combined or consolidated financial statements (where appropriate) if financial statements are required for two or more subsidiaries. Combined financial statements generally are appropriate only for entities under common control or common management, and then only for periods in which that condition existed.

**D. Summarized Financial Data**

Required if the investee falls in the 10% to 20% significance level (current & non-current assets and liabilities; redeemable stock and minority interests; revenues; gross profit; income from continuing operations; and net income). Summarized annual financial data should not be labeled "unaudited." [SX 4-08(g)] SB issuers are required
to provide summarized financial data if the investee is at least 20% significant. [SB 310(b)(2)(iii)]

E. **Foreign Investees**

Financial statements required by SX 3-09 for an investee that meets the definition of a foreign business need only comply with the reporting requirements of Item 17 of Form 20-F and are subject to the updating requirements of SX 3-19. Reconciliation requirements are described at Topic Six.

F. **Relief**

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

IV. **Other Financial Statements Required**

A. **Guarantors of Securities**

[Note: Refer to Division of Corporation Finance: Frequently Requested Accounting and Financial Reporting Interpretations and Guidance located under Current SEC Rulemaking - Other Commission Notices and Information on our website for guidance in this area. The Commission is expected to issue new rules applicable to guarantors of securities soon.]

B. **Collateralizations**

1. SX 3-10 requires registrants to file financial statements of each affiliate whose securities constitutes a substantial portion of the collateral for any class of security (collateral entities). SX 3-10 views guarantees and collateralizations as two separate disclosure matters. SAB 53 and our interpretations apply only to guarantors and does not apply to collateral situations, as the concepts of full, unconditional, and joint and several do not apply to collateralizations. Therefore, full audited financial statements of each affiliate whose securities constitute a substantial portion of the collateral of a security are required by SX 3-10.

2. Securities constitute a substantial portion of collateral if the greatest of the aggregate principal amount, par value, book value, or market value of the securities equals 20% or more of the principal amount of the secured class of securities.

3. Financial statements of collateral entities are required in registration statements, Forms 10-SB and Forms 10-K/10-KSB but not in Forms 10-Q/10-QSB.

C. **Third Party Credit Enhancements**

Third party credit enhancements differ from guarantees. A guarantee running directly to the security holder is a security within Section 2(1) of the Securities Act and must
be covered by a Securities Act registration statement filed by the guarantor, as issuer. A third party credit enhancement is an agreement between a third party and the issuer or a trustee that does not run directly to the security holders. 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 about the credit provider. The disclosure must provide sufficient information on the third party to permit an investor to determine the ability of the third party to fund the credit enhancement. In most cases, the disclosure of 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, statements prepared under statutory standards may be acceptable (e.g., statutory financial statements of insurance companies serving as credit enhancers).

The staff considers the following factors in assessing the sufficiency of the disclosure in this area:

- the amount of the credit enhancement in relation to the issuer's income and cash flows;
- the duration of the credit enhancement;
- conditions precedent to the application of the credit enhancement; and
- other factors that indicate a material relationship between the credit enhancer and the purchaser's anticipated return.

Financial information of a third party credit enhancement may also be required if an investor is reasonably likely to rely on a material credit enhancement in place for other debt (including nonpublic debt), even though the credit enhancement does not run directly to the debt being registered.

D. General Partner, Where Registrant is Limited Partnership. [SP]

1. Financial Statements Required in Transactional Filings

<table>
<thead>
<tr>
<th>If the General Partner is</th>
<th>Financial Statements Required</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporation</td>
<td>Audited balance sheet as of end of most recent fiscal year</td>
</tr>
<tr>
<td>Partnership</td>
<td>Audited balance sheet as of end of most recent fiscal year, and Financial statements of the partners if there is a commitment, intent or reasonable possibility that the general partner will fund cash flow deficits or furnish other direct or indirect financial assistance. [SP]</td>
</tr>
</tbody>
</table>
| Individual Unaudited balance sheet as of a recent date prepared in accordance with AICPA guidelines (SOP 82-1) furnished suplementally.  
The prospectus should disclose net worth. Also make appropriate disclosure if:  
• net worth is derived from material amounts of assets that are not readily marketable, or  
• guarantees and contingencies are material. |

| a) Age of financial statements  
The balance sheet should be updated on an unaudited basis if there has been a fundamental change in the financial condition of the general partner subsequent to the date of the audited balance sheet. Also updating on the same basis as the registrant is appropriate if the filing indicates a commitment, intent or reasonable possibility that the general partner will fund cash flow deficits or furnish other direct or indirect financial assistance. A general partner that is a public company must comply with the updating requirements of SX 3-12. The financial statements of a non-public general partner should be no more than 6 months old. [SP] |

| b) Where the general partner has significant oil and gas reserves, disclosures should include estimated year-end quantities, and estimated future net revenues and present values. [SAB 12A(3)(d)] |

| c) Where the general partner reports a substantial receivable from or investment in parent or affiliated company, or where the parent or affiliate commits to increase or maintain the general partner's capital (beyond IRS requirements), the audited balance sheet of the parent or affiliate should be provided. [SP] |

2. Periodic Reports  
Generally, inclusion of general partner's balance sheet is not mandatory in periodic reports. However, where investors are likely to be influenced by the financial condition of the general partner because of a general partner's commitment, intent or implication to fund cash flow deficits or furnish other direct or indirect financial assistance, the general partner’s balance sheet should be furnished. [SP]
E. **Parent-only Financial Statements (Condensed) [SX 5-04] [SX 9-06]**

Required as an S-X schedule where the restricted net assets of consolidated subsidiaries exceed 25% of consolidated net assets at most recent fiscal year-end. Also, GAAP requires this as a supplement to the financial statements where material. [ARB 51.24] The information prescribed by SX 12-04 should be presented in the footnotes of bank holding companies.

**What are “restricted net assets?”**

Restricted net assets is the amount of the registrant's share of subsidiaries' net assets (assets less the sum of liabilities, redeemable preferred stock, and minority interests) that may not be transferred to the parent in the form of loans, dividends, etc., without a third party's consent. [SAB 6K.2]

F. **Disposition of a business**

1. If authorization is sought from shareholders for disposition of a significant business, unaudited financial statements of that business should be provided in the proxy materials for the same periods as are required for the registrant (along with pro forma information). See PR Item 14(b)(1)(ii))D)

2. If disposition of a business is being accomplished through the registrant’s distribution to shareholders of its ownership interests in that business, audited financial statements of the separate legal “spinee” (which may not be the spinee for accounting purposes) for the same periods required for the registrant are required in a Form 10, Form 10-SB or ‘33 Act registration statement registering the shares being distributed.

G. **Other Financial Statements**

The staff may require other financial statements as necessary for a fair presentation of the financial condition of any entity whose financial statements are required. [SX 3-13]

* * * * *
Are Rule 3-05 Financial Statements Required in a Registration Statement for an Acquisition That Has Occurred or Is Probable? (Excludes S-4 Target Companies)

Is the acquiree a “Business” under 11-01(d) of Regulation S-X? No

Rule 3-05 does not apply.

Yes

Is this a Form S-4 or proxy statement? Yes

See special rules.

No

Is the acquiree’s significance ≥ 20%? No

Have the registrant’s financial statements already been restated to reflect the pooling? Yes

The acquiree’s financial statements are not required.

Yes

Purchase or pooling accounting? Pooling

Go to next page.

No

Purchase

Go to next page.
Continued from prior page.

Is the acquiree’s significance ≥ 50%?

Yes

Have the acquiree’s separate financial statements been filed previously and are its operating results included in the registrant’s financial statements for 9 months or more?

No

Is the registration statement being declared effective < 75 days after consummation of the acquisition?

Yes

Financial statements are not required in the registration statement, but Form 8-K with the acquiree’s financial statements is required to be filed no later than 75 days after consummation of the acquisition.

No

Have the acquiree’s separate financial statements been filed previously and are its operating results included in the registrant’s financial statements for 9 months or more?

No

The acquiree’s financial statements are required.

Yes

Is the acquiree’s significance ≥ 70% and have its operating results been included in the registrant’s financial statements for 21 months or less?

No

The acquiree’s financial statements are not required.

Yes

The acquiree’s financial statements are required.
Topic Three: Pro Forma Financial Information, Forecasts, and Forward Looking Information
(Article 11 of Regulation S-X)

This topic describes the circumstances in which pro forma financial statements should be furnished in filings, the form of their presentation, and guidance to be considered in their preparation. Although the specific rules of SX Article 11 do not apply to Small Business issuers, those registrants can consult SX Article 11 for guidance when preparing pro forma financial statements required by SB 310(d) for business acquisitions. Small Business issuers should present pro forma information for other current or probable transactions if that presentation would be material to investors. This topic also discusses the circumstances under which alternative or supplemental presentations of forecasts and forward looking information may be appropriate, along with guidelines for their content.

I. Circumstances Requiring Pro Forma Presentations

A. Significant Business Combination

1. A significant business combination has occurred in the latest fiscal year or subsequent interim period, or is probable. (See Topic Two for definition of a business and tests of significance.) Not required if the transaction is already reflected in historical statements as a pooling of interests or reorganization.

2. Additional pro forma information may also be appropriate if an acquiree of the registrant consummated a significant business combination of its own during the year, if that information would be material to an understanding of the registrant or a vote on a transaction.

3. Pro forma information required by SX Article 11 should be filed at the same time the audited financial statements of the target company are filed. Presentation of the acquiree’s financial statements without accompanying pro forma information can be misleading, and there is an expectation that the information required by Item 7 of Form 8-K will be furnished as promptly as feasible. The pro forma information furnished in connection with a Form 8-K filing reporting consummation of an acquisition is not expected to reflect definitive conclusions regarding allocation of the purchase price or other effects. However, uncertainties affecting the pro forma presentation and the possible consequences when they are resolved should be highlighted if they may be material.

B. Disposition of a Significant Portion of a Business

1. Disposition either by sale, abandonment or distribution to shareholders has occurred or is probable, and is not fully reflected in the historical financial statements.
2. Pro forma data may be relevant even if disposed operations do not satisfy the APB 30 criteria of a discontinued operation.

3. Since audited financial statements of the disposed entity generally are not required in the Form 8-K reporting the disposition, pro forma information should be filed within 15 days after the disposition. The 60-day extension available for filing financial statements and pro forma information for acquisitions is not available for dispositions.

C. Acquisition of One or More Real Estate Operations

Acquisitions which are in the aggregate significant have occurred in the latest fiscal year or subsequent interim period, or are probable. See Topic Two Section II for guidance related to aggregate significance tests for real estate acquisitions.

D. Roll-up Transaction [SK Item 914]

In connection with a transaction subject to the roll-up rules of SK 914, pro forma financial information should be presented showing the effect on the successor entity assuming (a) that all combining entities 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 entities. Consideration should be given to the need to present other variations of participation that are permitted by the terms of the roll-up. The following pro forma information should be furnished:

- 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

- Pro forma oil and gas reserve data, if applicable.
E. **Registrant Previously was Part of Another Entity**

Pro forma presentation may be necessary to reflect operations and financial position of the registrant as a stand-alone entity.

**NOTE:** Consider whether forward-looking information should be presented instead of or along with pro forma information, particularly in cases where a full set of audited financial statements of an acquired entity is not provided (e.g., audited statement of revenues and direct expenses). See Section II.K.

F. **Other**

Events or transactions have occurred or are probable for which disclosure of pro forma financial information would be material to investors, such as:

1. If the registrant’s historical financial statements are not indicative of the ongoing entity (e.g., tax or other cost sharing agreements terminated or revised). [SAB 1B-2]

2. Dividends declared by a subsidiary subsequent to the balance sheet. [SAB 1B-3]

3. Changes in capitalization at the effectiveness or the close of an IPO.

4. Receipt or application of offering proceeds under certain circumstances. See Section II.C.4(c)(6) and IV.B for further discussion.

5. Other events and transactions which have had or will have a discrete material impact on a registrant’s financial statements.

II. **Preparation Requirements - Form and Content**

A. **Objective**

SX Article 11 pro forma financial information is intended to provide investors with information about the continuing impact of a transaction by showing how a specific transaction or group of transactions might have affected historical financial statements, illustrating the scope of the change in the registrant’s financial position and results of operations.

The pro forma financial information should illustrate only the isolated and objectively measurable (based on historically determined amounts) effects of a particular transaction, while excluding effects that rely on highly judgmental estimates of how historical management practices and operating decisions may or may not have changed as a result of that transaction. Information about the possible or expected impact of current actions taken by management in response to the pro forma transaction, as if management’s actions were carried out in previous reporting periods, is considered a projection and not an objective of SX Article 11. Presentation of
forward looking and projected information should be confined to supplemental information separately identified as such (information that is not required or contemplated by Article 11) and in MD&A.

B. **Pro Forma Condensed Balance Sheet**

1. Pro forma presentation should be based on the latest balance sheet included in the filing. A pro forma balance sheet is not required if an acquisition is already reflected in a historical balance sheet, however disclosures related to balance sheet accounts would still be required.

2. Pro forma adjustments should be computed assuming the transaction was consummated on that balance sheet date.

3. Adjustments reflected in the pro forma adjustments column should give effect to events that are directly attributable to each specific transaction and factually supportable. Adjustments should include those items that have a continuing impact and also those that are nonrecurring.

C. **Pro Forma Condensed Income Statement**

1. Pro forma presentation should be based on the latest fiscal year and interim period included in the filing, unless the transaction is already reflected in those historical statements for 12 months. Unless the pro forma information gives effect to one of the two items below, a pro forma income statement should not be presented for more than one complete fiscal year. In addition to the required latest fiscal year and interim period, the staff will not object to a registrant providing a pro forma income statement for the corresponding prior interim period.

2. Pro forma presentation of all periods is required:
   a) for a business combination to be accounted for as a pooling-of-interests or a reorganization of entities under common control; or
   b) for discontinued operations (APB 30) that are not yet required to be reflected in historical statements.

**NOTE:** The staff generally objects to retroactive pro forma presentation of transactions for periods other than the latest year and interim period except in the circumstances described here. In some cases, retroactive presentations of revenues and costs of revenues may be meaningful for discussion of trends in MD&A, but more comprehensive presentations (through operating income, for example) can be misleading because they cannot meaningfully or accurately depict what operating results would have been had the transaction occurred at the earlier date.
3. Pro forma adjustments should be computed assuming the transaction occurred at the beginning of the fiscal year presented, and carried forward through any interim period presented.

4. Adjustments shall give effect to events that are:
   a) directly attributable to each specific transaction,
   b) factually supportable, and
   c) expected to have a continuing impact.

<table>
<thead>
<tr>
<th>Nature of Item</th>
<th>Treatment in Pro Forma Financial Information</th>
</tr>
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| (1) 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 following the transaction | • Do not include in pro forma income statements.  
• Disclose these items in a note and clearly indicate that they were not included. |
| (2) Infrequent or nonrecurring items included in the underlying historical financial statements of the registrant or other combining entities and that are not directly affected by the transaction | Do not eliminate in arriving at pro forma results.  
**For example:** Cheap stock charges or gains and losses on asset dispositions or liability settlements |
| (3) Conforming change in accounting principles adopted by registrant            | Pro forma information should consistently apply the newly adopted accounting principles to all periods presented. |
| (4) Discontinued operations, extraordinary items, or cumulative effects of accounting changes | If included in historical financial statements, present only the portion of the income statement through “income from continuing operations.” |
| (5) Earnings per share | Present historical basic and diluted per share data based on continuing operations and pro forma basic and diluted per share data on the face of the pro forma statement of operations.  
| | Also present the **number of shares** used to compute per share data if outstanding shares used in the calculation are affected by the transactions included in the pro forma financial statements. |
| (6) Use of proceeds and earnings per share | The **denominator** in computing pro forma EPS should include only those common shares whose proceeds are being reflected in pro forma adjustments in the income statements, such as proceeds used for debt repayment or business acquisitions.  
| | Common shares whose **proceeds** will be used for general corporate purposes, for example, should not be used in computing EPS. A company may present "additional" EPS data reflecting the issuance of all shares if it considers this information meaningful. If this additional EPS is shown on the face of the pro forma income statement, it should be labeled appropriately.  
| | The footnotes to the pro formas should make the computation(s) of pro forma EPS transparent to investors. |
D. Form

1. Columnar form, with separate columns presenting historical results, pro forma adjustments, and pro forma results. In limited cases, (where there are only a few easily understood adjustments) a narrative description of the effects of the transaction may suffice.

2. Preceded by introductory paragraph which briefly describes (a) each transaction for which pro forma effects are presented, (b) the entities involved, (c) the periods presented, and (d) an explanation of what the pro forma presentation shows.

3. Pro forma adjustments should be referenced to footnotes which clearly explain the assumptions involved.

4. Pro forma information may be in condensed form (similar to interim financial statements required in Form 10-Q) which reflects only those numbered captions of Regulation S-X. Any balance sheet caption less than 10% of total assets may be combined with others; any income statement caption less than 15% of average net income of the registrant for the last three years (excluding loss years) may be combined with others.

5. If the transaction is structured in such a manner that significantly different results may occur, additional pro forma presentations should be made which give effect to the range of possible results. The additional results may be of equal prominence or lesser, depending on the facts and circumstances. Additional presentations might include the following:

   a) Pro forma financial statements depicting minimum required issuances of securities or acceptance of offers along with separate pro forma depiction of maximum issuance or acceptance.

      • If the minimum or maximum outcome will only affect the balance sheet, the registrant need only present an additional pro forma balance sheet.

      • If the outcome of minimum or maximum participation does not have a pervasive impact on the financial statements, possible outcomes and their impacts may be discussed in a note to the pro forma financial statements.

      • If the number of offer acceptances in a proposed business combination may determine the accounting to be applied to the transaction (for example, purchase vs pooling of interests) and the only factor influencing the appropriate accounting is the number of acceptances, full pro forma financial information should be presented assuming each accounting method. If other factors may influence the accounting, pro formas should be based on the most likely accounting to be applied to the transaction based on due diligence performed by the registrant and its financial advisors.
b) Sensitivity analysis for a change in one variable which may produce different outcomes. Also see Section II.H for guidance regarding changes in interest rates.

*For example:* A registrant files a proxy statement requesting shareholder approval of a purchase business combination. The registrant will issue a certain number of common shares in the acquisition, the number of which will be determined by a formula such that the total dollar amount of the acquisition is subject to change. The registrant may present the pro forma effects of the acquisition using a purchase price calculated as if the acquisition was consummated at the date of filing (by using the most current trading price of the common shares). If the range of possible outcomes may have a material impact on the amount of goodwill to be recorded in the financial statements, the registrant should disclose the impact on the balance sheet and income statement (for amortization) of each dollar increase or decrease in the common share trading price.

6. Pro forma information for a particular acquisition or other transaction usually should be presented separately from pro forma information for unrelated transactions for which pro forma information may be required if:
   - the proceeds of an offering will be used to fund that acquisition, or
   - shareholders are being asked to vote on that acquisition or other transaction, or
   - a Form 8-K is required to be filed for that acquisition.

Other transactions appropriate for inclusion in a pro forma presentation should be accumulated in a separate column. Otherwise, if consummation of more than one transaction has occurred or is probable, pro forma information may be presented on either a combined or separate basis. If combined, footnote explanation should disaggregate the various transactions in a reasonable fashion.

**E. Accountant’s Reports**

An accountants’ report on pro forma financial information is not required. However, any auditor report provided on pro forma financial information must comply with AICPA guidelines as set forth in the “Statement on Standards for Attestation Engagements; Reporting on Pro Forma Financial Information.” The auditor’s consent should cover the report on the pro forma financial statements. Generally, reports on pro forma data are only appropriate where the auditor has a sufficient basis to express an opinion because it also audited the majority of the underlying historical financial statements and issued a report thereon.
F. **Typical Pro Forma Adjustments**

Generally, pro forma adjustments should be presented gross on the face of the pro forma statements. Alternatively, components of the adjustments may be broken out in a sufficiently detailed manner in the notes to the pro forma statements. [SP]

G. **In Business Combinations**

1. **Purschase Accounting**
   a) Pro forma statements that give effect to a business combination using the purchase method of accounting generally require only two pro forma adjustments; (1) the **allocation** of the purchase price, including adjusting assets and liabilities to fair value and recognizing intangibles, with related changes in depreciation and amortization expense, and (2) the effects of additional **financing** necessary to complete the acquisition. However, other related adjustments may be necessary.

   b) Contractual terms of the combination such as major **new compensation contracts** with management would require pro forma adjustment if the new contracts are entered into as part of the acquisition agreement. [SAB 2C]

   c) Actions to be taken by management subsequent to a business combination, as reflected in liabilities recorded in accordance with **EITF 95-3**, may relate to the planned disposal or termination of revenue producing activities, as well as other business integration activities. It is appropriate to present SX Article 11 pro forma adjustments depicting the recurring effects of exiting revenue producing activities. That type of pro forma adjustment is consistent with the requirement to provide pro forma information depicting material dispositions as discussed at I.B. Only revenues and costs specifically identifiable with that revenue-producing activity may be included in the pro forma adjustments. Allocations of corporate costs should not be adjusted for the disposition.

   d) Termination of employees and closing facilities are typical actions taken in connection with business combinations to eliminate costs perceived by management as redundant. The timing and effects of these actions are generally too uncertain to meet the SX Article 11 criteria for pro forma adjustments. Management’s estimate of how these actions (and other business integration activities not specifically associated with the disposition of a business) are expected to impact the operations and liquidity of the newly combined companies going forward should be discussed in MD&A and in supplemental information clearly identified as forward looking information.

   e) A schedule showing the **calculation of the purchase price** (including the value assigned to non-cash portions) should be provided in a note, if not otherwise reasonably apparent.

   f) The purchase price should be allocated to specific identifiable tangible and intangible assets (such as customer lists, contracts acquired, trademarks and
patents, in-process research and development, etc.) and liabilities. If the allocation is preliminary, significant liabilities and tangible and intangible assets likely to be recognized should be identified and uncertainties regarding the effects of amortization periods assigned to the assets should be highlighted.

g) 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 prominently that the purchase price allocation is preliminary. In this circumstance, the registrant should:

- describe clearly the nature of the contingency,
- discuss the reasons why the allocation is preliminary (i.e. identify the information that the registrant has arranged to obtain),
- indicate when the allocation is expected to be finalized, 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.

In the absence of such disclosure, investors may assume reasonably that the purchase price allocation is final and that all future revisions of estimated fair values of assets and liabilities acquired will be reflected in income. [SAB 2A.7]

h) If contingent consideration is issuable (as discussed in paragraph 77 of APB 16), the registrant should disclose the terms of the contingent consideration and the potential impact on future earnings.

i) The expected useful lives or amortization periods of significant assets acquired in a purchase business combination, including goodwill and other identified intangibles, should be disclosed in a note to the pro forma financial statements.

j) If amortization of purchase adjustments is not straight-line, the effect on operating results for the five years following the acquisition should be disclosed in a note, if material.

2. Pooling of Interests

a) Pro forma financial statements that present a merger accounted for as a pooling of interests merely combine two sets of historical financial statements. It is highly unusual to have pro forma adjustments other than elimination of any intercompany transactions and conforming of accounting policies. The resulting pro forma financial statements generally will be the same as those which the investor will see as the registrant’s actual financial statements after the transaction is consummated. If other transactions requiring pro forma presentation have occurred which affect one or both of the combining entities, those pro forma effects should be presented in a
separate column following the pro forma pooling results, for the most recent fiscal year and interim period only.

b) Compute **earnings per share** based on the aggregate of the weighted average outstanding shares of the constituent businesses, adjusted to equivalent shares of the surviving business for all periods presented. [FAS 128.59]

3. Any Business Combination

Either the registrant or its target may **expect to dispose of certain operations** in order for a merger to gain the approval of one or more US regulatory agencies. Pro forma recognition should be given to the impact of those disposals to the extent they are identifiable at the time the pro formas are prepared. If operations to be disposed of are not identifiable with any reasonable certainty at that time, the notes to the pro forma financial information should disclose the contingency and its reasonably possible impact on the financial statements. Pro forma financial information giving effect to the disposals should be filed on Form 8-K when the disposals occur.

**H. Pro Forma Presentations Reflecting Debt Financing**

1. Generally should be based on either the current interest rate or the interest rate for which the registrant has a commitment. If actual interest rates in the transaction can vary from those depicted, disclosures of the effect on income of a **1/8 percent variance** in interest rates should be disclosed.

2. Although use of current or committed interest rates is appropriate in most cases, careful consideration should be given to the facts and circumstances specific to each presentation to **determine whether the interest rate used is reasonable**. Certain limited circumstances may warrant the use of an interest rate other than the current or committed rate. In some instances, the staff believes that the registrant should use the interest rates that were prevailing during the period covered by the pro forma information.

**For example:** If a registrant purchases a business whose assets comprise variable rate interest earning assets financed by variable rate debt, it may be inappropriate to use current interest rates for purposes of computing pro forma interest expense if historical income amounts related to interest earning assets are reflected using interest rates significantly different from current or committed rates.

When a rate other than the current or committed rate is used, prominent disclosure of the basis of presentation and the anticipated effects of the current interest rate environment should appear in the introduction to the pro forma financial statements and wherever pro forma information is provided. [SP]
I. Tax Effects

Normally should be calculated with reference to the statutory rate in effect during the periods for which the pro forma income statements are presented. If taxes are not calculated on that basis, or if unusual effects of loss carryforwards or other aspects of tax accounting are depicted, explanation should be provided in a note to the pro forma financial statements.

J. Effects of New Contractual Arrangements

Effects of new major distribution, cost sharing, or management agreements, and compensation or benefit plans may only be reflected if amounts can be factually supported, are directly attributable to the transaction, and are expected to have a continuing impact on the statement of operations.

For example: A formal management agreement between a registrant or target subsidiary and its parent that provides for payments intended to cover administrative costs incurred by the parent on behalf of the subsidiary may be terminated or modified. If a new agreement is executed with different terms or the old agreement is terminated and no new agreement is entered into because the subsidiary or its new parent will now perform the activities covered by the previous management agreement, pro forma adjustment for the contractually modified fee may be made. [SP]

K. “Carved Out” Businesses

1. A forecast about post-acquisition results of operations may be more meaningful than a pro forma statement of operations prepared in accordance with SX Article 11 when historical financial statements of the acquiree are not indicative of financial condition or results of operations going forward because of the changes in the business and the omission of various operating expenses in the financial statements of businesses carved out of larger entities. Refer to V for guidance regarding forecasts.

2. If a pro forma statement of operations is furnished, management should present within the pro forma information its best estimate of what any allocated or omitted corporate costs would have had the merger taken place as of the beginning of the earliest period presented. [Instruction 4 to SX Article 11] (See Topic Two, I.A.3.b for guidance about form and content of carve out financial statements.) That information should be clearly identified as forward-looking either in a note to the pro forma adjustments or in a separate pro forma statement column heading. Material assumptions should also be fully explained in a note. The adjustments should be limited to those demonstrating the effects of the changes in operations that may have affected historical revenues or operating expenses had they been implemented at the beginning of the historical period. The limitations of the pro forma information should be explained clearly.
III. Special Problems and Issues

A. Common Pro Forma Preparation Problems

The following adjustments generally are not appropriate on the face of the respective pro forma financial statements, but could be disclosed in the footnotes thereto.

1. Interest income from the use of proceeds from an offering or asset sale.

2. Income statement presentation of gains and losses directly attributable to the transaction. However, such amounts should be presented as an adjustment to pro forma retained earnings with an appropriate explanation in the notes.

3. Pro forma adjustments that give effect to actions taken by management or expected to occur after a business combination, including termination of employees, closure of facilities, and other restructuring charges. Forecasts or projections may be the most appropriate way to depict the effect of such actions.

4. There generally should be no adjustments in the acquiree’s historical allowance for loan losses, insurance reserves or other contingent liabilities. Ordinarily, such adjustments imply that the historical financial statements of the acquiree require revision to conform with GAAP. However, a pro forma adjustment may be appropriate if the acquiring entity intends on a substantially different method of disposing problem loans (bulk sale). [SAB 2A.5] Refer to SAB 2A.9 for a discussion of liabilities assumed in a purchase business combination.

5. Alternative measures of performance or liquidity and the effect of pro forma adjustments thereon.

B. Prohibition On Assuming Offering Proceeds [33A-170]

1. Pro Forma financial statements may not reflect the receipt or application of offering proceeds, except as follows:
   a) to the extent of a firm commitment from underwriter;
   b) to the extent of the minimum in a best-efforts minimum/maximum offering;
   c) in a best-efforts all-or-none offering; and
   d) certain exceptions for savings and loan conversions.

2. A similar prohibition applies to pro forma capitalization tables, except the staff has accepted the following:
   a) In a minimum/maximum offering, presentation at both minimum and maximum; and
   b) In a rights offering or offerings of securities upon the exercise of outstanding warrants, to the extent exercise is likely in view of the current market price.
C. Combining Entities with Different Fiscal Years

1. An acquired entity’s income statement should be brought up to within 93 days of the registrant’s fiscal year, if practicable, by adding subsequent interim results to the fiscal year’s data and deducting the comparable preceding year interim results, with appropriate disclosure. [SX 11-02(c)(3)]

2. For business combinations accounted for using the pooling-of-interests method of accounting, the financial statements of the combining companies may differ by more than 93 days. However, financial statements of the fiscal year in which the pooling is consummated must be recast so that the combined periods do not differ by more than 93 days. The resulting adjustment is reflected as an adjustment of stockholders’ equity. An accompanying footnote explaining the basis of combination should include disclosure of sales or revenues, net income before extraordinary items, and net income for any period excluded from or included more than once in the recast financial statements. [SX 3A-02]

3. Additional quantitative and narrative disclosure about gross profit, selling and marketing expenses, and operating income of any period excluded from or included more than once may be necessary to inform readers about the effects of unusual charges or adjustment in the omitted or double counted period. [SP]

D. Historical Results Include Unusual Events [SX 11-02(c)(4)]

If unusual events enter into the determination of operating results presented for the most recently completed fiscal year, the effect of such unusual events should be disclosed and the registrant should consider presenting an additional pro forma statement of operations for the most recent 12-month period. The effects of the unusual events ordinarily should not be eliminated from pro forma data. The registrant may wish to consider furnishing a forecast in lieu of pro forma data. See Section V.

IV. Special Applications

A. Sub-Chapter S Corporations and Partnerships [SP]

1. If the issuer was formerly a Sub-S, partnership or similar tax exempt enterprise, pro forma tax and EPS data should be presented on the face of historical statements for the periods identified below.

   a) If necessary adjustments include more than adjustments for taxes, limit pro forma presentation to latest year and interim period.

   b) If necessary adjustments include only taxes, pro forma presentation for all periods presented is encouraged, but not required.

2. In filings for periods subsequent to becoming taxable, pro forma presentations reflecting tax expense for earlier comparable periods should continue to be
presented for periods prior to becoming taxable and for the period of change if the
registrant elects to present pro forma information for all periods pursuant to
IV.A.1.b above. Such pro forma presentations should continue to calculate the
pro forma tax expense based on statutory rates in effect for the earlier period.

3. Undistributed earnings or losses of a Sub-S registrant should be reclassified to
paid-in capital in the pro forma statements. [SAB 4B] Similarly, undistributed
earnings or losses of partnerships should be reclassified to paid-in capital in the
pro forma statements. That presentation assumes a constructive distribution to the
owners followed by a contribution to the capital of the corporate entity.

4. Sub-S registrants or partnerships that pay distributions to promoter-owners at the
close or effectiveness with proceeds of the offering (rather than out of retained
earnings) should consider the pro forma presentations specified in Section IV.C.3
below.

B. Distributions to Promoters/Owners At or Prior to Closing of IPO [SAB 1B.3]

1. 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 accrual (but not giving effect to the offering proceeds) should be
presented along side the historical balance sheet in the filing.

2. 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, 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 (but only the amount that
exceeds current year’s earnings) in addition to historical earnings per share. 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.

C. Other Changes in Capitalization At or Prior to Closing of IPO [SP]

1. Generally, the historical balance sheet and statement of operations (including
EPS) should not be revised to reflect modifications of the terms of outstanding
securities that become effective after the latest balance sheet date, although pro
forma data may be necessary. If the registrant and its independent accountants
elect to present retroactively a conversion of securities as if it had occurred at the
date of the latest balance sheet included in the filing (with no adjustment of earlier
statements), the staff ordinarily will not object. However, if the original
instrument accrues interest or accretes toward redemption value after the balance
sheet date until the conversion actually occurs, or if the terms of the conversion do
not confirm the carrying value, only pro forma presentation would be deemed appropriate.

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

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

**D. Pro Forma Requirements for Real Estate and Leasing Operations**

1. Statements of estimated taxable operating results and cash to be made available by operations are required. These should be pro forma statements of the registrant, rather than of the property, giving effect to the acquisition.

   a) If the property is to be operated by the registrant, the presentation should be based on the most recent 12 month period and include only those adjustments which are factually supportable. Annualized results for a period less than twelve months is not appropriate.

   b) If the property to be acquired is subject to one or more leases, the presentation should be based on the rents to be paid in the first year of those leases. Material changes in the terms that will occur pursuant to the terms of the leases subsequent to the first year should be prominently disclosed.

   c) Registrants that are partnerships or REITs may present in tabular form for a limited number of years, typically one year, the estimated cash distribution per unit showing the portion thereof reportable as taxable income and the portion thereof that is a return of capital. If taxable net income will be greater than the cash available for distribution per unit, this should be disclosed.

2. To the extent applicable, pro forma information required by SX Article 11 is also required.

3. Pro forma presentations should not include the effects of real estate properties for periods prior to actual construction since that type of adjustment would be a forecast or projection.

4. The provision of SX 3-14 which permits estimated taxable operating results of real estate companies to include annualization of existing lease contracts is not applicable to equipment leasing companies or other businesses that generate income through leases.
V. Projections and Financial Forecasts

A. Alternative to Pro Forma Statements

Financial forecasts may be presented in lieu of pro forma statements of operations, or they may presented for other informational purposes. [SX11-03]

B. Presentation Requirements

1. All projections and forecasts must comply with the guidelines for projections in Item 10 of Regulation S-K and S-B. Item 10 requires that management have a reasonable basis for the assumptions underlying their prospective financial statements. Similarly, sections 210 and 316 of the AICPA Guide for Prospective Financial Statements require these assumptions to be reasonably objective with persuasive support. Support for assumptions include market surveys, industry data, general economic indicators, historical operations, signed contracts, etc. An absence of adequate support may preclude a registrant’s ability to include prospective financial statements in the filing. Additionally, a company with a limited operating history may not have a reasonable basis to present a financial forecast beyond one year.

2. Forecasts presented in lieu of pro forma financial statements must be presented in accordance with AICPA guidelines, and the following:

   a) Cover a period of at least 12 months from the later of; (a) the latest historical balance sheet in the filing, or (b) the date of the event.

   b) Same degree of detail as that required in pro forma data; assumptions are clearly set forth.

   c) Historical information of the registrant and business to be acquired (if applicable) should be presented for a recent 12 month period in parallel columns with the forecast.

VI. Other

A. Pro Forma Disclosures Required by GAAP

Certain “pro forma” disclosures are required by GAAP (e.g. APB16, 20 and certain EITF consensuses) and should be provided where applicable. Those presentations may differ in style and content from the requirements of SX Article 11.

* * * * *
Topic Four: INDEPENDENT ACCOUNTANTS' INVOLVEMENT
(Article 2 of Regulation S-X)

I. Qualifications of Accountants

A. Duly registered and in good standing under the laws of his or her place of residence or principal business.

1. Licensure status should be confirmed with appropriate personnel in OCA if the accounting firm is unfamiliar to the staff.

2. SX 2-01 requires that an independent accountant be licensed and in good standing under the laws of the place of the accountant’s residence or principal office. The rule is silent as to whether or not the accountant’s state or country of licensure must coincide with the location of the registrant’s corporate offices or place where the registrant conducts its principal operations.

a) The staff interprets SX 2-01 to require the audit report on a domestic registrant’s financial statements to be rendered by an auditor licensed in the US. However, the staff has made limited exceptions in the circumstance of a domestic shell company registrant where substantially all operations are foreign, and the audit report is rendered from the location of the principal business.

b) In any event, an auditor whose report is included in a domestic registrant’s filings should be an expert in US GAAP and US GAAS. In circumstances where the audit report is not rendered in the US, the staff should inquire about the steps the auditor has taken to obtain competency in US GAAP and compliance with US GAAS. Notify DCAO of instances where the audit report on a domestic registrant’s financial statements was rendered by a non-US auditor.

B. Independent. [FR 602]

1. All independence questions should be referred through DCAO to the Commission’s OCA.

2. An accountant is not independent if he or she has any direct, or material indirect, interest in the client. The Commission's rules are more restrictive than AICPA guidelines regarding the association of the accountant's family members and retired partners with the client. The Commission also is more restrictive as to the extent of services (particularly recordkeeping) that may be provided to an audit client.
3. Independence rules also apply to Regulation A and Regulation D filings. [FRC 602.02(a)]

C. Indemnification

Indemnification of parties subject to liability under the U.S. securities laws is considered contrary to public policy. Indemnification also may impair an auditor’s independence (FRC 602.02.i.i). The staff does not object to a domestic or foreign registrant’s indemnification of predecessor auditors for costs incurred in successful defense of claims. However, the current auditor may not be indemnified under any circumstances. Any auditor indemnification arrangement should be described under “Experts” in a registration statement.

D. Principal Auditor

1. A principal auditor must take responsibility for the financial statements of the registrant for each year presented, although that auditor may refer to other auditors whose reports and audits are being relied upon by the principal auditor. The principal auditor is expected to have audited or assumed responsibility for reporting on at least 50% of the assets and revenues of the consolidated entity. If it is impracticable for a principal auditor to assume that extent of responsibility for one or more of the periods presented, the staff will evaluate whether to accept the audit reports as sufficient for reliance in filings with the Commission depending on the facts and circumstances. The staff should encourage registrants that are unable to obtain a report from an auditor assuming that degree of responsibility to consult with the staff well in advance of filing.

2. The staff has not objected to a principal auditor's report solely on the basis that the auditor is taking responsibility for less than 50% of the assets and revenues of the registrant if that report is issued by an auditor required to be designated as the principal auditor because of the laws, regulations, stock exchanges rules, or similar circumstances applicable to the registrant.

E. AICPA SEC Practice Section

Independent accountants are not required to be members of the AICPA or the AICPA SEC Practice Section to practice before the Commission. However, the AICPA requires a member of the AICPA that issues a report on financial statements of a company after it has become subject to the Commission's reporting requirements to be a member of the AICPA SEC Practice Section.

II. Accountant’s Report

A. General

1. Basic requirements: dated; signed; indication of City and State where issued; identify the financial statements covered.
2. The report should refer to any supplemental schedules furnished pursuant to SX Article 12 (or a separate report on those schedules may be included with the schedules).

3. The report must contain clear statements as to scope, opinion and any exceptions taken. It must include representations that the audit is conducted in accordance with GAAS and that financial statements are presented in conformity with GAAP. All audits of financial statements filed with the Commission must be conducted in accordance with U.S. GAAS. All financial statements must be prepared in accordance with U.S. GAAP, except as permitted by Item 17 or 18 of Form 20-F.

4. If an audit report required to be filed includes reference to another accountant's report, the separate report of the other accountant must also be included in the filing.

5. Auditors' reports referring to each period for which audited financial statements are required must be included in the filing, except that only audit reports opining on the most recently completed fiscal year are required in an Annual Report to Shareholders. Including only an audit report on the current period precludes the incorporation by reference of those financial statements into the Form 10-K unless the audit reports for previous years are separately included or incorporated by reference from another document. [PR 14a-3]

B. Qualified Reports

The audit report that an independent auditor may be required to issue under GAAS may indicate that either the financial statements or the audit procedures applied do not satisfy the requirements of the form or the Commission's rules. Examples of audit reports that always represent a substantial deficiency in the filing include the following:

1. Scope qualifications [SAB 1E.2]
   a) Any qualification with respect to the scope of the audit results in a finding by the staff that the audit of the financial statements required by Commission rules has not been performed.
   b) Sometimes an auditor is not present for observation of inventory. In that case, the auditor must be able to satisfy himself or herself through alternative procedures. No language in the report should imply a qualification as to scope or conclusions. [FRC 607.01]

2. Disclaimer of opinion
   SX Article 2 requires the clear expression of an opinion on the financial statements. A report that states that the auditor is disclaiming an opinion for any reason does not satisfy the requirements of SX Article 2.
3. Qualifications as to accounting principles or disclosures  [SAB 1E]

Financial statements not in conformity with GAAP are presumed to be inaccurate or misleading, notwithstanding explanatory disclosures in footnotes or in the accountant's report. [FRC 101]

C. Other Report Modifications

1. Emphasis of a matter [AU 508.19]

Auditors are permitted, but not required, to include the emphasis of a matter in their reports regarding:

- the entity is a component of a larger entity
- significant related party transactions
- subsequent events
- issues (such as changes in accounting) that affect the comparability of financial statements
- other matters that are of such a character as to warrant emphasis to investors.

The staff should be alert to language in an audit report that emphasizes an uncertainty. That language may be indicative of a scope limitation, or may be presented in a fashion that can confuse readers as to the conclusions reached by the auditor with respect to amounts presented in the financial statements. Audit reports that emphasize or otherwise refer to uncertainties, other than going concern modifications, should be brought to the attention of DCAO.

2. Going concern modifications [AU 341]

a) Going concern modifications are required by GAAS in certain circumstances.

b) Filings that include reports having going concern modifications must also include appropriate and prominent disclosure of the financial difficulties giving rise to that uncertainty. Discussion of a viable plan that has the capability of removing the threat to the continuation of the business must be included. The plan may include a "best efforts" offering so long as the amount of minimum proceeds necessary to remove the threat is disclosed. The plan should enable the issuer to remain viable for at least the 12 months following the date of the financial statements being reported on. If management has no viable plan, the use of going concern financial statements should be questioned. [FRC 607.02]

c) Going concern opinions that do not use the words "substantial doubt" when referencing a going concern matter do not comply with GAAS.

d) Going concern opinions that are phrased as a conditional uncertainty, that is, they indicate that substantial doubt will arise if an event occurs or fails to occur, are not appropriate.
e) A disclaimer of opinion resulting from going concern matters is permitted by SAS 59, but does not comply with the requirements of SX Article 2.

3. Changes in accounting principles

a) A reference in the audit report is required if there has been a change in accounting principles applied that materially affects the comparability of financial statements presented.

b) A registrant filing an initial public offering is permitted a special exemption to retroactively apply a change pursuant to APB 20.29. However, disclosures of the nature of the change and the justification for a change, including an explanation of why the newly adopted accounting principle is preferable, are required by APB 20.17 and .30.

c) Preferability Letters

The presumption that an entity should not, in the absence of the promulgation of a new accounting standard, change an accounting principle may be overcome only if the enterprise justifies the use of an alternative acceptable accounting principle on the basis that it is preferable. [APB 20.16] The registrant is required to file a letter from its independent accountant concurring with its conclusion as to the new method's preferability. [SAB 6G.2.b] In all cases, the staff should evaluate the reasonableness of the new accounting policy and ensure adequate disclosure of its effects. In the absence of authoritative literature providing another basis for evaluating preferability, the registrant's determination should be based on its own particular circumstances and reflect management's business judgment.

(1) Preferability letters must be included in Form 10-Q or Form 10-K as Exhibit 18 and need only be filed once in the first applicable Exchange Act filing following the change. Preferability letters are not required in Securities Act filings. A preferability letter generally is required in Form 10-K only when a change in accounting occurred in the fourth quarter. Even though the independent accountant referred to the change in its audit report as required by GAAS and thus concluded as to the preferability of the change, Regulation S-K requires that a preferability letter be included as an exhibit to the Form 10-K.

(2) The staff has objected to the change from one acceptable method to another acceptable method if the registrant and its independent accountants cannot demonstrate that the new method is preferable. Conforming to industry practice may not justify a change if industry practice is not the preferable method.

(3) Preferability letters are generally not required after a purchase business combination where changes in the acquired entity's accounting are made to conform to those of the acquiring entity.
(4) For a business combination accounted for as a pooling of interests, a preferability letter is required if the registrant issuer changes its accounting principles. A preferability letter is not required when the other combining company changes accounting principles to conform to the registrant’s accounting.

(5) A preferability letter is required for a change in estimate effected by a change in accounting principle.

(6) No preferability letter is required if the change is in response to newly issued category A or category B GAAP, a SAB, or an EITF Consensus.

(7) GAAP hierarchy for evaluating preferability or resolving conflicts in guidance is as follows [AU 411.10]

| Category A                  | • FASB Statements of Financial Accounting Standards  
|                            | • FASB Interpretations  
|                            | • APB Opinions  
|                            | • AICPA Accounting Research Bulletins  
|                            | • Rules and interpretive releases of the Commission have authority similar to Category A GAAP for SEC registrants.  
| Category B                  | • AICPA Industry Audit Guides  
|                            | • AICPA Statements of Position  
|                            | • FASB Technical Bulletins  
| Category C                  | • AcSEC Practice Bulletins  
|                            | • FASB EITF Consensus Positions  
| Category D                  | • AICPA Interpretations and Implementation Guides  
|                            | • Widely recognized and prevalent practices  

**NOTE:** In addition, the staff would challenge any accounting that differs from an **EITF consensus** even though it is considered Category C GAAP by the AICPA. The staff believes that EITF consensus issues represent the best thinking on areas for which there are no specific standards.
III. Review and Compilation Reports

A. Review Reports on Interim or Pro Forma Data

1. Prior to filing, interim financial statements included in quarterly reports on Forms 10-Q and 10-QSB must be reviewed by an independent public accountant using professional standards and procedures for conducting such reviews, as established by generally accepted auditing standards, as may be modified or supplemented by the Commission. If, in any filing, the company states that interim financial statements have been reviewed by an independent public accountant, a report of the accountant on the review must be filed with the interim financial statements. Otherwise, the report is not required to be included in Forms 10-Q and 10-QSB.

2. An accountant issuing a review report on interim data is presumed to not have adequate knowledge of the company's accounting and financial reporting policies unless he has also audited the prior fiscal year. [AU 722.09 & SP] Likewise, an accountant issuing a review report on pro forma data should have conducted an audit of a significant portion of the historical data in the pro forma presentation. See also Topic Three, I.E. [SP]

3. Consent to inclusion of the report, in the form discussed in Section 605 of the Codification of Financial Reporting Policies, should be included.

B. Selected Quarterly Financial Data

1. Required for all registrants except foreign private issuers, mutual life insurance companies and small business issuers filing on small business forms. If it is required to be furnished, it must be reviewed by the independent accountant. [ SK 302]

2. No reference in the audit report to the quarterly data accompanying the annual financial statements is necessary if the auditor's review conformed with applicable standards and the auditor is not aware that the interim information is materially affected by a departure from GAAP. Otherwise, the auditor must discuss the departures that exist.

3. If a significant charge or credit is reported in a quarter the staff may question whether the adjustment should have been recognized in whole or in part in an earlier quarter. The staff will also consider the need to confirm that (1) the auditor made reasonable inquiry as required by review standards and (2) the auditor has not referred to the interim data because they have concluded that there is no reason to believe that any departure from GAAP related to the adjustment materially affected interim information.
C. Compilation Reports

Compilation reports are not appropriate in any filings, including Regulation A filings, because the association of the accountant provides no basis for reliance. [SP]
IV. Change in Accountants; Disagreements

[SK 304]

A. Change in Accountants

1. If a change in accountants occurred within 24 months prior to or in any period subsequent to the date of the most recent financial statements, the registrant should provide required information
   - in Form 8-K within 5 business days of the change
   - in proxies, even though previously disclosed in Form 8-K
   - in registration statements, unless the change was previously disclosed.

2. Disclose:
   - whether the accountant resigned, declined to stand for reelection or was discharged, and the date of resignation or discharge;
   - whether the decision was recommended or approved by the Board of Directors or committee thereof; and
   - whether the accountant had issued a report in the last two fiscal years containing a disclaimer or adverse or qualified opinion.
   - whether in connection with audits of the two most recent years through the date of resignation or discharge there were any disagreements with the former accountants on any matter which, if not resolved to the satisfaction of the accountants, would have caused the accountant to make reference in its report to the matter. This includes disagreements which were resolved to the satisfaction of the accountant. The filing should describe the subject matter of any such disagreement.

3. If the registrant amends the Item 4 disclosures for any reason it must also file as Exhibit 16 an updated letter from the auditor addressing the revised disclosures.

B. Unusual Issues Involving Changes in Accountants

1. New accountant hired prior to termination of prior accountant
   A registrant may engage a new auditor prior to termination of the predecessor accountant who is completing the audit of the current fiscal year. A termination occurs on the date the registrant hires a new accountant. The registrant should file an Item 4 Form 8-K when it formally engages the new auditor. The Item 4 Form 8-K should report the change, identify disagreements or reportable events and include the predecessor auditor's letter. The registrant should file an amendment on Form 8-K within five days after it files the predecessor auditor's final audit report on the registrant's financial statements. The amendment should indicate whether there are any disagreements through that date and include a confirming auditor's letter.
2. Reverse acquisition

Unless the same accountant reported on the most recent financial statements of both the registrant and the accounting acquirer, a reverse acquisition always results in a change in accountants. A Form 8-K filed in connection with a reverse acquisition should provide the disclosures required by SK Item 304 under Item 4 of Form 8-K for the change in independent accountants, treating the accountant that no longer will be associated with the registrant’s financial statements as the predecessor accountant.

3. The disclosures required by Item 304 with respect to any changes in the accounting acquirer’s auditor which occurred within 24 months prior to, or in any period subsequent to, the date of the acquirer’s financial statements must be provided in the first filing containing the accounting acquirer’s financial statements.

V. “To Be Issued” Accountant’s Reports

A. Contingent Upon Future Event or Transaction

If audited financial statements are required in a filing, the audit report should be signed and unrestricted. Generally, the staff should not commence a review of a filing that does not meet that requirement. However, if the entities comprising the registrant will not be legally transferred to the registrant in a reorganization until immediately before effectiveness, the staff has accepted filing of a "draft" report in the form that it will be expressed at effectiveness. In that case, the draft report should be accompanied by a signed preface of the auditor stating that it expects to be in a position to issue the report in the form presented at effectiveness. No registration statement can be declared effective until the preface is removed and the accountant's report finalized. If a filing does not include a currently effective audit report for reasons other than as described here, DCAO should be advised promptly.

B. Contingent Upon Future Underwriting Agreement

If a report is restricted solely to avoid issuing a modified report because of doubt about the registrant's continued existence and the modification would be removed upon receipt of proceeds from offering, the accountant's report should reflect such modification in the registration statement upon effectiveness. [SP]

VI. Other Matters

A. Consents to the Use of Audit Reports

1. Registrants must file a copy of the auditor's consent to the use of its report in any filing under the Securities Act as an exhibit. The primary purpose of obtaining
consent is to assure that the auditor is aware of the use of its report and the context in which it is used.

2. A new consent is required:
   • whenever any change, other than typographical, is made to the financial statements
   • for an amendment if there have been intervening events since the prior filing that are material to the company
   • with an amendment if an extended period of time passes since the last filing. An extended time is generally any period which is more than 30 days. Many firms require their clients to obtain a new consent each time an amendment is filed.

3. Exchange Act reports
   a) Filing of a consent to the use of an audit report is not required in Exchange Act reports. Ordinarily, an auditor's engagement letter with the registrant will require the registrant to inform the auditor prior to each occasion that the report is filed with the Commission. Audit reports included in Exchange Act filings are required to be signed.
   b) An amendment to a previously filed Exchange Act filing may require the reissuance of the auditor's report. In other circumstances, it may be sufficient to include a manually signed report or consent that affirms that the originally filed report applies to the financial statements and/or schedules as revised in the amendment.

4. Waivers [SAB 1A and SAB 1L]
   a) In rare circumstances, such as situations involving hostile takeover attempts, a consent may be waived if the registrant applies for a waiver and provides an affidavit complying with Rule 437 of Regulation C.
   b) Hostile takeovers
      A registrant offering its own securities in a hostile exchange offer for a target’s stock may seek and not be able to obtain the target’s cooperation in providing either its audited financial statements or the target auditor’s consent to the use of its report in the required registration statement. The acquirer/registrant should use its best efforts to obtain the target’s permission and cooperation for the filing or incorporation by reference of the target’s financial statements and the target auditor’s consent to the inclusion of its report on the financial statements. At a minimum, a registrant is expected to write to the target requesting these items and to allow a reasonable amount of time for a response prior to effectiveness of the filing. The target may, however, fail to cooperate with the registrant.
If a registrant uses its best efforts but is unsuccessful in obtaining the target’s permission and cooperation for the filing or incorporation by reference of its financial statements and its auditor’s consent to the inclusion of its report on the financial statements, the registrant may request a waiver of the consent. The affidavit included in the request should document the specific actions taken by the registrant to obtain the cooperation of the other party for the filing as well as the efforts to obtain the auditor’s consent. Correspondence evidencing the registrant’s request for these items should accompany the affidavit.

The staff will generally agree to waive the requirement to include or incorporate by reference the target auditor’s audit report. In that situation, disclosure should be made that, although an audit report was issued on the target’s financial statements and is included in the target’s filings, the auditor has not permitted use of its report in the registrant’s registration statement. The auditor should not be named. Any legal or practical implication for shareholders of the registrant and the target resulting from the inability to obtain the cooperation of the target or consent of the target’s auditor should be explained. No disclosure in the registration statement should expressly or implicitly disclaim the registrant’s liability for the target’s financial statements. In the event that circumstances change, the registration statement should be amended to include the audited financial statements and the auditor’s consent required by the form.

5. The consent of the independent accountant is not required for a report on financial statements which is not a part of a 1933 Act registration statement under Rule 412(c) of Regulation C, like superseded financial statements.

The staff has not objected to a modified consent language indicating that the independent accountant's report on financial statements previously filed on Form 10-K and incorporated by reference in Form S-3 is no longer appropriate since restated financial statements have been presented giving effect to a business combination accounted for as a pooling-of-interests. This language is only appropriate where the pooling-of-interest combination is consummated and the financial statements have been restated as a result of the publication of post-combination financial statements. That is, this does not apply to supplemental financial statements.

**B. Withdrawal of Audit Report [AU 561 and SP]**

When an auditor becomes aware of information in interim periods which relates to financial statements previously reported on and that information would require revision of the financial statements and/or the auditor’s report, the auditor must notify the Commission (through OCA) that the report must no longer be relied upon. If a registrant publicly discloses that previously filed audited financial statements require adjustment and the auditor has not withdrawn its report, confusion for investors as to
the auditor’s concurrence with the adjustments may result. In this situation, the registrant should clarify in the filing the extent of reliance on the audit report.

C. Accountants’ Refusals to Re-issue Reports

Some accounting firms have adopted risk management policies that lead them to refuse to reissue their reports on the audits of financial statements that have been included previously in Commission filings. In some cases, accountants whose reports on acquired businesses were included in a registrant's Form 8-K have declined to permit that report to be included in a registrant's subsequent registration statement. In other cases, accountants have declined to reissue their reports on the registrant's financial statements after the registrant engaged a different auditor for subsequent periods. The Commission's staff is not in a position to evaluate the reasons for an accountant's refusal to re-issue its report and will not intervene in disputes between registrants and their auditors. Moreover, the staff will not waive the requirements for the audit report or the accountant's consent to be named as an expert in filings. If a registrant is unable to re-use the previously issued audit report in a current filing, the registrant must engage another accountant to re-audit those financial statements. A registrant that is unable to obtain either re-issuance of an audit report or a new audit by a different firm may be precluded from raising capital in a public offering.

D. Illegal Acts

Section 10A of the Exchange Act requires that auditors report in a timely manner certain uncorrected illegal acts to a registrant’s board of directors. It further requires the registrant, or the auditor if the registrant fails to do so, to provide information regarding the illegal act to the Chief Accountant of the Commission. Notify DCAO immediately upon any indication from a registrant or its auditor that an illegal act has occurred.

E. Signatures

Wherever a signature is required, typed signatures or duplicated or facsimile versions of the manually signed document may be used. In any of these cases, each signatory must manually sign the document authenticating, acknowledging or otherwise adopting the signature that appears in the filing before or at the time that the filing is made, and the manually signed document must be retained by the filer for five years. A copy of this document must be furnished to the Commission upon request. [ST 302]

F. Selected Financial Data

1. An auditor may be engaged to report on selected financial data using the guidance of SAS 42. Identification of some or all columns of selected financial data as "audited" or other references to the auditor can create the impression that the registrant has so engaged the auditor. If no auditor association with the selected financial data has occurred but an investor could obtain such an impression from
the manner of presentation, the staff should recommend revision of that presentation. A statement in a headnote to the data that the amounts presented for the fiscal year are derived from audited financial statements does not create the impression that the information was subject to a SAS 42 examination.

2. If an auditor was engaged to report on the selected financial data, the form of report specified by SAS 42 should be included in the filing and the auditor's consent to the report should make reference to its applicability to the selected financial data.

G. Miscellaneous

1. The financial statements should not appear on the accountants' letterhead, and should not refer in any way to the accountants' report. [TPA 9410.06]

2. The terms "audited" and "certified" have the same meaning in the Commission's regulations. [SAB 1E.1]

3. The accountant's report should not refer to unaudited interim financial statements even where they are presented along side of audited fiscal year data. [AU 504.14] Such data should be clearly labeled as unaudited.

4. Additional disclosures are required if an auditor report of a bankrupt accounting firm is included in a filing. [SAB 1L]

* * * * *
Topic Five: SMALL BUSINESS ISSUERS  
Regulation S-B

I. Definition and Eligibility

A. Must meet all of the following five conditions [SB 10]:

1. Annual revenues of less than $25 million, as reported in its most recent fiscal year (12 months) for which audited financial statements are prepared in accordance with U.S. GAAP.

   a) New reporting companies

      A company that has not previously reported to the Commission must meet the revenues test based on the most recent fiscal year for which audited financial statements are included in the initial registration statement. However, if, consideration of the pro forma effect of (1) businesses acquired during the latest fiscal year, and (2) consummation of business combinations identified as probable at the time of filing the initial registration statement would result in the issuer exceeding the revenue limit, the issuer would not qualify for use of the S-B form.

   b) Previously reporting companies

      A previously reporting company must meet the revenues test based on its annual audited financial statements as originally filed with the Commission (not restated for subsequent pooling-of-interests transactions or discontinued operations) for the two most recent fiscal years.

   c) Banks and similar financial institutions

      For purposes of the test, a bank must include all gross revenues from traditional banking activities. Banking activity revenues include interest on loans and investments, dividends on investments, fees from loan origination, fees from trust and investment services, commissions, brokerage fees, mortgage servicing revenues, and any other fees or income from banking or related services. Revenues do not include gains and losses on dispositions of investment portfolio securities (although it may include gains on trading account activity if that is a regular part of the institution's activities).
2. **U.S. or Canadian issuer.** A small business issuer that ceases to be incorporated in the U.S. or Canada is immediately disqualified from the S-B reporting system.

3. **Not an investment company.** A small business issuer that becomes an investment company is immediately disqualified from the S-B reporting system.

4. **Parent, if any, must qualify.** If the issuer is a majority owned subsidiary, the parent entity also must be a small business issuer. An entity that is to be spun off from its parent coincident with or prior to its initial registration may register as a small business issuer if it will otherwise qualify as small business issuer upon consummation of the spin-off.

5. **Public float less than $25 million.** An entity is not a small business issuer if it has a public float (the aggregate market value of the issuer's outstanding securities held by non-affiliates) of $25 million or more. Apply the public float test as follows:

<table>
<thead>
<tr>
<th>Reporting company</th>
<th>The public float test of a reporting company is computed using the price at which the stock last sold, or the average bid/ask prices of such stock, on a date within 60 days prior to the end of its most recent fiscal year.</th>
</tr>
</thead>
<tbody>
<tr>
<td>New Registration - Exchange Act</td>
<td>The public float of a company filing an initial registration statement under the Exchange Act shall be determined as of a date within 60 days of the date the registration statement is filed. Float shall be computed on the basis of the number of all shares outstanding held by non-affiliates prior to the filing of the registration statement and the estimated public price of the securities.</td>
</tr>
<tr>
<td>New Registration - Securities Act</td>
<td>In the case of an initial public offering under the Securities Act, public float shall be computed on the basis of the number of shares outstanding held by non-affiliates prior to the offering and the estimated public offering price of the securities.</td>
</tr>
</tbody>
</table>

**B. Regular Reporting Company Changing to S-B Reporting System**

A reporting company may enter the S-B system only at the beginning of a fiscal year, and must determine at the time of its first filing in a fiscal year (first quarterly report, Form 8-K, or registration statement) whether it will enter the S-B reporting system. A reporting issuer cannot enter the S-B system during a fiscal year if it has already filed Exchange Act reports for periods included in that fiscal year under Regulation S-X.
reporting company may enter the S-B system if it meets both the revenue and the public float test for each of the last two fiscal years.

C. Continued Eligibility to Use the S-B Reporting System

1. Small business issuers wishing to remain in the S-B system must file all Exchange Act reports including Form 8-K, following the requirements of Regulation S-B beginning with the first Exchange Act report in a given fiscal year, or with the first Exchange Act report following effectiveness of the initial S-B registration statement.

2. A company may continue to use the Small Business Issuer forms until it exceeds the revenue limit for two successive fiscal years or it exceeds the public float limit at the end of two consecutive fiscal years. The revenue test is applied to the annual financial statements originally filed with the Commission, not as restated for subsequent discontinued operations or pooling of interests.

3. S-B issuers are permitted to use Form S-1, or any other form for which they qualify, at any time provided that all the requirements of that form are met (including the financial statement requirements). The use of Form S-1 does not disqualify the registrant from filing subsequent Exchange Act reports pursuant to S-B so long as it continues to meet the S-B eligibility requirements. [SB 10(a)(2)(v)]

4. A company may exit the S-B reporting system voluntarily at any time by filing a required report or registration statement on a non-S-B form. After a company has filed using a non-S-B form, it may not re-enter the S-B reporting system until the following fiscal year (with the exception of 3 above), at which time it must satisfy the requirements for a reporting company entering the S-B system.

5. If a S-B issuer becomes a majority-owned subsidiary of a domestic company that is not a small business issuer or a foreign private issuer during the year, the S-B issuer may finish the year reporting under the S-B system. With the start of the next new year, the registrant must report under the S-X/S-K system.

6. For purposes of proxy and information statements, as well as subsequent Form 10-K’s, the small business issuer that has exited the S-B reporting system need not provide the additional disclosures required by Regulations S-X and S-K with respect to fiscal years during which it was an S-B filer. However, registration statements filed by former S-B filers must comply fully with the requirements of the registration form.

II. Other Eligibility Issues
| A. Date for determining eligibility | Eligibility for Forms SB-1 and SB-2 with respect to the revenues and public float tests is determined on the date that the form is filed and at 33A-10(a)(3) update time, with the exception of C below. Therefore, transactions subsequent to the filing date and prior to the date of effectiveness do not affect the use of the form. |
| B. 3-05 or 3-09 financial statements of SX filer | A non-S-B registrant required to furnish financial statements under SX 3-05 or 3-09 may not rely on accommodations in Regulation S-B with respect to the acquired business or investee even though that business would satisfy the tests as a small business or investee. |
C. **Finalization of year end financial statements**

If a reporting company believes it has met the test as a small business issuer for each of the past two fiscal years it may file, immediately after the latest year end, a registration statement using an S-B Form. If it is determined after the financial statements for the latest fiscal year has been finalized that the company does not qualify as a small business issuer, then an amendment must be filed before effectiveness converting the filing to a non-S-B form and complying with the requirements of Regulation S-K and Regulation S-X.

D. **Business acquisitions**

An S-B reporting company generally continues to qualify for use of S-B forms after the acquisition of another company that is not S-B reporting or S-B eligible until the revenue or public float limits are exceeded for two successive fiscal years.

E. **Reverse acquisitions**

- The staff considers "reverse acquisitions" with non-operating public shells to be capital transactions in substance, rather than business combinations. Accordingly, the staff looks to the accounting acquirer's eligibility as a small business issuer.

- If a reverse acquisition occurs in which a non-public operating company is deemed to be the acquirer of an SB public operating company (registrant), the registrant (the legal acquirer) would continue to be SB eligible. In circumstances where the transaction appears to be an initial public offering of a larger, dominant accounting acquirer, the staff may look to the accounting acquirer’s eligibility as a small business issuer. Refer to Appendix B.

- If the accounting acquirer is a public operating company that reports under Regulations SK and SX, the registrant will no longer be S-B eligible.
F. Other financial statements may be required

A primary goal of the S-B reporting system is to reduce the impediments to small business financing in the securities markets without compromising the basic protection of investors. Where consistent with the protection of investors, the staff may require the filing of other financial statements where necessary or appropriate. In situations where a small business issuer acquires a company reporting under the Exchange Act pursuant to Regulations S-K and S-X, the staff may require 3 years of audited financial statements for the acquired entity, since those financial statements are already required to be furnished. Further, the staff may raise additional questions as to the eligibility to use the S-B forms after the acquisition.

III. Form and Content Disclosures Required by Regulation S-X are Not Applicable

A. General

Small business issuers need not comply with the disclosure requirements of Regulation S-X, except as indicated under the "NOTES" to Item 310 of Regulation S-B.

The staff, based on the AICPA Statement on Auditing Standards No. 69, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report, views Staff Accounting Bulletins (SABs) and Financial Reporting Releases (FRRs) to be interpretations of GAAP, and, in most cases, should be applied.

Small Business Issuers must provide all information required by the Industry Guides, and real estate companies should also refer to Item 13 [Investment Policies of Registrant], Item 14 [Description of Real Estate], and Item 15 [Operating Data] of Form S-11.

B. Pro Forma Information

Pro forma financial statements are required in transactional filings whenever a significant business combination has occurred or is probable, and the transaction has not been reflected in at least nine months of historical audited financial statements of the issuer. In addition, pro forma financial information should be furnished whenever consummation of an event or transaction has occurred or is probable for which disclosure of pro forma information would be material to investors. Issuers should consider the guidance in SX Article 11.

NOTE: SB issuers are not required to present pro forma information for periods prior to the periods for which financial statements are required.
For example: Pro forma information depicting a business combination to be accounted for as a pooling of interests requires two years and interim period, not three years.

C. Significant Equity Investees

The disclosure about significant equity investees cited under Item 310(b)(iii) of Regulation S-B is required in both interim and annual financial statements.

D. Canadian Issuers

Canadian small business issuers that present financial statements in accordance with Canadian GAAP shall include a reconciliation to U.S. GAAP that complies with Item 18 of Form 20-F for registration statements (with certain exceptions). The requirements of Item 17 need only be met for financial statements included in periodic reports and certain registration statements. [Note 2 to SB 310]

* * * * *
Topic Six: FOREIGN PRIVATE ISSUERS & FOREIGN BUSINESSES

I. Definitions and Basic Rules

A. Definitions

<table>
<thead>
<tr>
<th>Foreign Issuer</th>
<th>An issuer which is foreign government, a foreign national or a corporation or other organization that is incorporated or organized under the laws of any foreign country.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign Private Issuer</td>
<td>A foreign issuer that is not a foreign government. If U.S. residents own more than 50% of its voting securities, all of the following must also be true: (a) Majority of its executive officers and directors are not U.S. citizens or residents, (b) More than 50% of the value of its assets is located outside the U.S. and (c) Its business is administered principally outside the U.S.</td>
</tr>
<tr>
<td>Foreign Business</td>
<td>A foreign business is not organized under the laws of the U.S. or any state thereof, is majority owned by persons who are not U.S. citizens or residents and: (a) More than 50% of its assets are located outside the U.S. or (b) Majority of its executive officers and directors are not U.S. citizens or residents.</td>
</tr>
</tbody>
</table>

**NOTE:** In its determination of the majority ownership of a business, the staff will consider the ultimate parent entity that would consolidate the business under U.S. GAAP and its controlling shareholders.

B. Basic Rules

1. Foreign private issuers are eligible to use Form 20-F and the other "F forms" which provide certain financial statement and disclosure accommodations.

*Can a foreign private issuer elect to use the registration and reporting forms that domestic companies use?*
Yes. However, if it elects to do so, it must comply with all of the requirements of the “domestic company” forms.

2. A foreign issuer--other than a foreign government--that does not meet the definition of a foreign private issuer, must use the same registration and reporting forms as a domestic company. A foreign issuer that loses its foreign private issuer status becomes subject to the reporting requirements for a domestic company on that date. While previous Exchange Act filings do not have to be amended upon the loss of foreign private issuer status, all future filings would be required to fully comply with the requirements for a domestic company. The financial statements and selected financial data should be recast into U.S. GAAP and U.S. dollar reporting currency for all periods presented.

3. If a Canadian company is required by law to prepare financial statements in accordance with Canadian GAAP, the staff will not object to it using Canadian GAAP and Canadian dollars in filings with the Commission even if it does not meet the definition of a foreign private issuer. However, it should file on domestic forms and provide a reconciliation to U.S. GAAP under Item 18 of Form 20-F. Companies incorporated in a foreign country other than Canada that do not meet the definition of a foreign private issuer are required to use U.S. GAAP to prepare their financial statements filed with the Commission.

4. Reincorporation of a foreign private issuer as a U.S. entity generally will require a 1933 Act registration statement on a domestic form (S-4). All periods must be restated to U.S. GAAP/U.S. dollars.

II. General Financial Statement Requirements for Foreign Private Issuers

A. *Periods for which Financial Statements are Required [Item 8 of Revised Form 20-F]*

1. **Audited** financial statements required in a registration statement or annual report:

<table>
<thead>
<tr>
<th>Balance Sheet</th>
<th>Income Statement</th>
<th>Shareholders' Equity</th>
<th>Cash Flow Statement</th>
<th>Comprehensive Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>2 years</td>
<td>3 years</td>
<td>3 years</td>
<td>3 years</td>
<td>3 years</td>
</tr>
</tbody>
</table>
2. **Unaudited** interim financial statements required:

   a) Registration statement

<table>
<thead>
<tr>
<th>Financial Statement</th>
<th>Period Required</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance Sheet</td>
<td>As of interim date</td>
</tr>
<tr>
<td>Income Statement, Cash Flow Statement and Comprehensive Income</td>
<td>For period from latest fiscal year end to the interim balance sheet date and corresponding period in prior year.</td>
</tr>
<tr>
<td>Shareholders’ Equity</td>
<td>Current interim period.</td>
</tr>
</tbody>
</table>

   b) Periodic interim reports

   Foreign private issuers that file annual reports on Form 20-F are required only to furnish promptly, in a Form 6-K, material information:

   (i) Distributed to stockholders or to a national exchange, if made public by that exchange, or

   (ii) Required to be made public by its domestic laws. [EAR 15d-13(b) & 13a-13(b)]

B. **Age of Financial Statements in a Registration Statement**  [Item 8 of Revised Form 20-F]

   **NOTE**: Item 8 of revised Form 20-F will supersede SX 3-19 effective for registration statements first filed after September 30, 2000 and annual reports that include financial statements for fiscal years ending on or after September 30, 2000. The guidance contained in this section reflects the Form 20-F revisions. Refer to old SX 3-19 for the age requirements for financial statements contained in filings that precede the effective date.

   1. Financial statements of a foreign private issuer must be as of a date within 9 months of the effective date of a registration statement. Audited financial statements for the most recent completed fiscal year must be included in registration statements declared effective 3 months or more after fiscal year-end. Under the rule, foreign private issuers can go effective with audited financial statements as old as 15 months, with the most recent interim statements as old as 9 months. If interim statements are required, they must cover a period of at least 6 months.
NOTE: Foreign private issuers use Form 20-F as both an Exchange Act registration statement and an annual report form. An Exchange Act registration statement on Form 20-F is sometimes referred to as a “20-FR”. The age of financial statements requirements under Item 8 of revised Form 20-F apply when Form 20-F is used as a registration statement.

2. The 15 month period for audited statements is extended to 18 months, and the 9 month period for interim statements is extended to 12 months, for the following offerings:
   - exercise of outstanding rights granted pro rata to all existing securityholders;
   - dividend or interest reinvestment plan; or
   - conversion of outstanding convertible securities or exercise of outstanding transferable warrants. [Item 8 of revised Form 20-F]

3. Special Rule for IPOs - Audited financial statements in initial public offerings must be no more than 12 months old at the time of filing. However, this rule applies only where the registrant is not public in any jurisdiction. Further, the staff will waive the 12-month requirement where compliance is not required in any other jurisdiction and it is impracticable or involves undue hardship. [Item 8 of revised Form 20-F]

4. The age requirements in Item 8 of revised Form 20-F also apply to financial statements of:
   - foreign businesses acquired by both foreign and domestic registrants under SX 3-05
   - foreign target businesses required in Form S-4 or Form F-4
   - foreign equity investees of both foreign and domestic registrants under SX 3-09.

5. A foreign private issuer that has been in existence less than a year must include an audited balance sheet that is no more than 9 months old. [SP]

6. If financial information reporting revenues and income for an annual or interim period more current than required by the rule is made available to shareholders, exchanges, or others in any jurisdiction, that information should be included in the registration statement.
   a) The more current information is not required to be reconciled to U.S. GAAP. However, a narrative explanation of differences in accounting principles should be provided, and material new reconciling items should be quantified. Differences between foreign and U.S. GAAP can be identified by cross reference to U.S. GAAP reconciliation footnotes elsewhere in the filing.
   b) If a new U.S. accounting standard would be required to be applied in the period for which the updated information is provided, that fact should be
disclosed, but no quantification of the effect is necessary if unreasonable cost or delay would be required. [Item 8 of revised Form 20-F]

7. Acquired and to be acquired foreign businesses under SX 3-05

Financial statements of acquired and to be acquired foreign businesses under SX 3-05 must comply with the age of financial statement requirements at the time of effectiveness of the registration statement. Interim financial statements for the period preceding the acquisition date may not be omitted on the basis that the acquisition occurred during the first 9 months of the current year. However, the financial statements generally need not be updated if the omitted period is less than 6 months, and the acquired business does not prepare quarterly financial statements under its home-country reporting requirements.

8. Age of pro formas in cross-border business combinations

Also see Section IV.A.7 for additional guidance on preparation of pro forma financial information.

a) The age of the pro forma financial information included in a registration statement is based on the age of financial statements requirement applicable to the registrant. If a foreign private issuer files a Form F-4 and the target company is a U.S. domestic registrant, the age of the pro forma information may be determined by reference to Item 8 of revised Form 20-F. By contrast, if a U.S. domestic registrant files a Form S-4 and the target company is a foreign private issuer, the age of the pro forma information must be determined by reference to SX 3-12.

b) Application of the age of financial statement rules may require the foreign target company to include in a Form S-4 a period in the pro forma information that would be more current than its separate historical financial statements. However, SX Article 11 permits the ending date of the periods included for the target company to differ from those of the registrant by up to 93 days. The staff will also consider combinations of periods that involve overlaps or gaps in the information of the target company of up to 93 days, provided that the resulting annual and interim periods are of the same length required for the registrant, and there are no overlaps or gaps in the registrant’s information. However, the staff would not permit a registrant to omit an interim pro forma presentation because of different fiscal periods.

9. In certain circumstances, the staff will consider special processing needs for cross-border offerings which involve special problems of coordination among several national jurisdictions. Foreign issuers should direct requests for special processing to the Office of International Corporate Finance in advance of filing.
C. Due Date for Annual Reports on Form 20-F

1. General rule

An annual report on Form 20-F is required to be filed within 6 months after the foreign private issuer’s fiscal year-end.

2. Special Report on Form 20-F triggered by an IPO

   a) When an IPO is made effective within 6 months after a foreign private issuer’s fiscal year-end and the audited financial statements of the just recently completed year are not included, the following reporting requirements apply:

| If the registrant is subject only to the Exchange Act reporting requirements of Section 15(d): | A Special Report* on Form 20-F must be filed by the later of 90 days after effectiveness or 6 months after fiscal year-end. A complete annual report on Form 20-F is not required until the following fiscal year. [EAR 15d-2] |
| If the registrant is registered under Sections 12(b) or 12(g): | An annual report on Form 20-F must be filed within 6 months after the fiscal year end. [EAR 13a-1; Form 20-F] |

* This Special Report should contain the audited financial statements of the just recently completed year. It does not need to include MD&A or other narrative disclosures ordinarily required in a Form 20-F; but, registrants are encouraged to provide that information. To comply with the rules of the exchange on which they are listed (not Commission rules), companies may need to file a complete Form 20-F, rather than a Special Report. Even if omitted from a Special Report, MD&A and other omitted information needs to be included in any subsequent registration statement or proxy.

D. Continuous and Shelf Offerings

Foreign private issuers are required to update the financial statements and other information included in a prospectus used more than nine months after effectiveness of a registration statement only when the financial statements would be as of a date later than the date of financial statements required under Item 8 of revised Form 20-F. Issuers filing on Form F-3 may incorporate by reference reports filed or furnished to the Commission that contain the updated financial statements rather than filing a post-effective amendment. [SK 512(a)(4)]
### E. Changes in Fiscal Year [EAR 15d-10(g) & 13a-10(g)]

1. Transition reports for foreign private issuers are filed on Form 20-F as follows:

<table>
<thead>
<tr>
<th>Transition period is:</th>
<th>In a transition report on Form 20-F, include:</th>
<th>File the transition report within:</th>
</tr>
</thead>
</table>
| More than 6 months     | • Audited financial statements reconciled to U.S. GAAP  
                          • All information required to be filed when Form 20-F is used as an annual report. | Later of 6 months after either the end of the transition period or the date the issuer elected to change its fiscal year-end. |
| 6 months or less, but more than one month | • Unaudited financial statements, reconciled to U.S. GAAP  
                                             • Information required by Items 3, 9, 15, 16, and 17 or 18 of Form 20-F.  
                                             NOTE: The next annual report on Form 20-F must include audited financial statements for this transition period. | Later of 3 months after either the end of the transition period or the date the issuer elected to change its fiscal year-end. |
| One month or less      | No separate filing is required but the one-month transition period must be audited and included in the next annual report on Form 20-F. | No separate filing is required. |

2. The staff will consider requests for a transition period of more than 12 months if a longer period is accepted in the issuer's home country. Issuers that receive this accommodation are required to provide complete unaudited financial statements with all of the applicable disclosures for both the 12-month period and the remaining portion of the transition period.

3. Foreign private issuers filing a registration statement after electing to change their fiscal year end may need to provide more current audited financial statements than are required under the Exchange Act transition reporting rules. A foreign private issuer’s most recently audited financial statements cannot exceed the age specified by Item 8 (generally 15 months) at the registration statement’s date of effectiveness.

### III. Requirement for Reconciliation to U.S. GAAP

Foreign private issuers are allowed to prepare the primary financial statements filed with the Commission in accordance with a comprehensive body of GAAP other than U.S. GAAP. To assist U.S. investors in understanding the nature of the accounting
differences and their effects on financial statements, foreign issuers are required to provide a reconciliation to U.S. GAAP.

A. Requirement for Reconciliation By Registrant

1. General
   a) A reconciliation is required for each annual and interim period required to be included in a registration statement or annual report.
   b) Form 20-F provides two levels of reconciliation to US GAAP - Item 17 and Item 18. Item 18 requires the same information as Item 17 plus all of the disclosures required by U.S. GAAP and Regulation S-X. With certain limited exceptions, Item 18 is required for securities offerings. Some of these exceptions include:
      - offerings pursuant to reinvestment plans
      - offerings upon the conversion of securities
      - offerings of investment grade securities

Item 17 is acceptable in these instances and for purposes of the annual report. Many foreign issuers elect to file their annual reports under Item 18 and provide all of the disclosures required by U.S. GAAP and Regulation S-X. Issuers that file using Item 17 may be required to provide certain additional information in the MD&A to assist the U.S. investor in understanding the financial statements. [SAB 1D].

2. First-time entrants to U.S. reporting system
   a) If a foreign registrant has not previously filed financial statements with the Commission on a reconciled basis, it is only required to provide reconciliations of the financial statements and selected financial data to U.S. GAAP for the two most recently completed fiscal years and for any interim periods required in the registration statement. In each subsequent year, on a prospective basis, an additional year of the reconciliation is required. This accommodation also applies to financial statements filed pursuant to SX 3-05 and 3-09.

   NOTE: While reconciliations to U.S. GAAP are initially only required for two years, the registrant’s financial statements still need to be presented in the registration statement for all of the periods required by Item 8 of revised Form 20-F. Similarly, selected financial data still needs to be presented for five years, even though the oldest three years need not be reconciled to U.S. GAAP.
b) First time registrants that elect to prepare the financial statements in accordance with U.S. GAAP may provide income statements and statements of cash flows for only their two most recent fiscal years. However, selected financial data still needs to be presented for five years under home-country GAAP if U.S. GAAP financial data is not available for the oldest three years. MD&A need only discuss the two years presented in the financial statements. [R33-7053]

c) Predecessor financial statements and selected financial data must be presented in the same comprehensive body of accounting as the registrant. A foreign entity that is a predecessor of a U.S. domestic company must present financial statements in U.S. GAAP and U.S. dollars.

3. Issuers of investment grade debt

Forms F-1, F-2, F-3 and F-4 allow registration of investment grade securities utilizing the simpler reconciliation requirements of Item 17 of Form 20-F.

4. “Backdoor” listings by foreign companies

a) Foreign companies sometimes obtain a “backdoor” listing through a reverse acquisition with a U.S. public shell. Even though substantially all of the operations are conducted outside of the U.S., the registrant would not be considered a foreign private issuer.

b) To facilitate timely reporting, the staff would not object if the financial statements included in the Form 8-K are prepared using a foreign GAAP, provided a reconciliation to U.S. GAAP that complies with Item 18 of Form 20-F is provided.

c) The first Form 10-K and any registration statement should include financial statements prepared using U.S. GAAP for all periods presented, including those prior to the reverse acquisition. Financial statements in a foreign GAAP reconciled to U.S. GAAP would not be acceptable.

5. Financial Statements of Foreign Acquired Businesses or Foreign Equity Investees

a) The reporting requirements of Form 8-K do not apply to foreign private issuers. However, foreign private issuers must comply with SX 3-05 in registration statements.

b) If financial statements are required to be filed by registrants (domestic or foreign) for foreign acquirees or foreign equity investees, these statements may be prepared on a basis other than U.S. GAAP. Reconciliations to U.S. GAAP must be provided only when the foreign acquiree or foreign equity investee is significant to the registrant at the 30% level or greater. Refer to Topic Two for the tests of significance. [Item 17(c)(2)(v) and (vi) of Form 20-F]
6. If reconciliation is required, the financial statements of foreign acquirees or foreign investees need only comply with the reconciliation requirements of Item 17 of Form 20-F, rather than Item 18. Even though the significance level of an acquisition may require the presentation of three years of audited financial statements in a registration statement or other transactional filing, the reconciliation only needs to be reconciled for the most recent two years and any required interim period.

7. If three years of audited financial statements of an acquired foreign business would be required based on the level of significance, a registrant may elect to present the acquired business’ statements for only two years if they are prepared using U.S. GAAP, rather than foreign GAAP with a reconciliation. In applying this accommodation, the registrant’s primary financial statements must also be prepared in accordance with U.S. GAAP if post-acquisition periods are considered in determining the years presented.

8. A foreign or domestic registrant may apply SAB 80 in determining the periods for which audited financial statements of acquired foreign businesses are required in an IPO. Assuming that the businesses acquired are reporting in the U.S. for the first time, financial statements of foreign businesses required to be presented under the SAB for three years need only be reconciled to U.S. GAAP for the two most recent fiscal years. Financial statements required to be presented under the SAB for two years must be reconciled to U.S. GAAP for both years. Most recent interim period and corresponding prior year financial statements also would be reconciled to U.S. GAAP.

B. Selected Financial Data [Item 3A of revised Form 20-F]

1. Selected financial data should include amounts under U.S. GAAP, if different. The selected data should be provided for 5 years.

2. Selected data for the earliest two years of the five year period may be omitted if the registrant represents that the information cannot be provided without unreasonable effort or expense, and states the reasons for the omission in the filing.

IV. Content of Reconciliation to U.S. GAAP

Form 20-F provides two levels of reconciliation to U.S. GAAP--Item 17 and Item 18. Item 17 permits the registrant to use its financial statements that are prepared on a comprehensive basis other than U.S. GAAP but requires quantification of the material differences in the principles practices and methods of accounting. An issuer complying with Item 18 must satisfy the requirements of Item 17 and also must provide all other information required by U.S. GAAP and Regulation S-X. The distinction between Items 17 and 18 is premised on a classification of the requirements of U.S. GAAP and Regulation S-X into those that specify the methods of measuring the amounts shown on
the face of the financial statements and those prescribing disclosures that explain, modify or supplement the accounting measurements. [SAB 1D]

A. **Item 17 Requirements**

1. A **discussion of material variations** in accounting principles, practices and methods used in preparing the financial statements between foreign GAAP and U.S. GAAP.

2. A quantified description of **balance sheet differences** under foreign GAAP in comparison to U.S. GAAP. Most companies elect to present this information in the form of a reconciliation of shareholders’ equity, but they may also provide restated balances of individual balance sheet line items, or describe, in numerical terms, how balance sheet line items would specifically change under U.S. GAAP.

   **NOTE:** The reconciliation of shareholders’ equity should be in sufficient detail to allow an investor to determine the differences between a balance sheet prepared using foreign GAAP and one prepared using U.S. GAAP.

**Common deficiencies include:**

a) Recording reconciling items net of taxes.  
   All reconciling items should be presented gross with a separate adjustment for taxes.

b) Presenting adjustments that impact several balance sheet captions as one reconciling item.  
   Disclose the impact on each caption for adjustments that impact several captions, such as purchase accounting.

c) Not reflecting adjustments at the subsidiary level.  
   Each GAAP adjustment should be made at the appropriate subsidiary level to determine the impact on items such as minority interest, taxes and the currency translation adjustment.

d) Recording adjustments for items such as PP&E or goodwill, net of depreciation and amortization expenses.  
   These adjustments should be presented gross with separate disclosure of the amounts of accumulated depreciation and amortization.

   **NOTE:** Registrants should supplementally prepare statements of changes in shareholders’ equity using balances determined under U.S. GAAP as a proof that the reconciliation balances and that it provides appropriate disclosure on changes in the equity accounts on a U.S. GAAP basis. Many registrants elect to include these statements, prepared using U.S. GAAP balances, in the financial statements.
Unless easily determined from the information in the financial statements, the staff should request this information supplementally as a part of the comment process.

3. A **reconciliation of net income** from foreign GAAP to U.S. GAAP that quantifies and describes each significant difference.

4. Disclosure of basic and diluted EPS calculated in accordance with U.S. GAAP, if materially different from foreign GAAP.

**Item 17 registrants are also encouraged to:**
- Disclose the number of shares used to determine basic and diluted EPS under U.S. GAAP, and
- Describe any differences between the methods utilized to determine the numerators and denominators in the calculations of EPS under U.S. GAAP and the foreign GAAP

*(This information is required for Item 18 registrants.)*

5. A **cash flow statement** prepared under U.S. GAAP or IAS 7, or a reconciliation of a cash flow statement or statement of changes in financial position that quantifies the material differences in the statement presented as compared to U.S. GAAP. Some of the more common deficiencies in this disclosure include:

   a) failure to identify noncash investing and financing activities;

   b) presentation of items on a net rather than gross basis;

   c) inadequate discussion of the differences in the definitions of “cash” and “cash equivalents”; and,

   d) differences in classification.

   Issuers are encouraged to supplementally prepare a statement of cash flows prepared in accordance with U.S. GAAP to confirm the adequacy of the disclosure of the reconciling items.

6. A reconciliation for each required supplemental schedule from foreign GAAP to U.S. GAAP that quantifies and describes each significant difference.

7. SX Article 11 pro forma financial statements should either be prepared on a U.S. GAAP basis or be accompanied by quantified reconciliations to U.S. GAAP prepared in a manner consistent with Item 17. Reconciliations of pro forma information to U.S. GAAP are required even if the historical financial statements of the acquired business are not required to be reconciled. See Section II.B.8 for guidance concerning age of pro forma information. A method consistent with FAS 52 should be used to translate currencies.
8. Disclosure of the accounting method used in the reconciliation to U.S. GAAP for stock-based compensation given to employees and to non-employees. Other than this information, issuers filing under Item 17 are not required to provide the pro forma and other disclosures stipulated in FAS 123.

9. Segment information under FAS 131 need not be provided if the information about separate categories of activity required under Item 1 of Form 20-F is provided in the filing.

10. The disclosures required by FAS 7 for development stage companies should be provided since they are part of the primary financial statements.

B. Item 18 Requirements

1. Certain information is required to be disclosed under Item 18, but not Item 17. For example (list not all inclusive):

   a) Reconciliations of the numerators and denominators used in computing basic and diluted EPS, and other EPS-related disclosures (FAS 128)
   b) Segment information (FAS 131)
   c) Fair value information (FAS 107)
   d) Concentrations of credit risk (FAS 105)
   e) Information about investment securities (FAS 115)
   f) Information about off-balance sheet financial instruments (FAS 119, FAS 133)
   g) Pro forma and other disclosures about stock-based compensation to employees and non-employees (FAS 123)
   h) Components of pensions and benefits other than pensions (FAS 87, FAS 106, FAS 132)
   i) Components of tax expense and deferred tax liability/asset (FAS 109)
   j) Income statement classification differences

2. Pervasive Impact of Differences between Home-Country and U.S. GAAP

   If differences between home-country and U.S. GAAP have such a pervasive impact on the financial statements that they render a normal reconciliation as described above confusing to investors, full or condensed financial statements prepared in accordance with U.S. GAAP may be necessary in order for the reader to fully understand the impact of the differences in accounting.

   For example: A business combination accounted for as a purchase of another company by the registrant under home-country GAAP but as a reverse acquisition under U.S. GAAP (the registrant is acquired by another company) would most easily be understood if the registrant included, in addition to a description of the differences in accounting, audited financial statements prepared under U.S. GAAP. Those financial statements would reflect the change in basis of the registrant on the acquisition date and present the financial statements of the accounting acquirer prior to the date.
of acquisition as the financial statements of the registrant (see Appendix B for additional guidance related to reverse acquisitions)

C. Statements of Comprehensive Income

1. Statements of comprehensive income prepared using either U.S. GAAP or home-country GAAP are required for both Item 17 and Item 18 issuers. These statements may be presented in any format permitted by FAS 130. Reconciliation to U.S. GAAP is encouraged, but not required.

2. Paragraph 26 of FAS 130 requires the presentation of the components of the accumulated balance of other comprehensive income items either on the face of the financial statements or in the footnotes. This requirement does not apply to Item 17 filers.

3. In certain countries, equity components under home-country GAAP are included in retained earnings and are not separately tracked. Reconstruction of these amounts may not be practical. The staff will generally not object if an Item 18 filer concludes, and discloses in its filings, that it is not practical to present the components of the accumulated balance of other comprehensive income items specified by paragraph 26 of FAS 130.

D. Accommodations

1. Cash flow statement

   The Commission will accept without reconciliation to U.S. GAAP a foreign issuer's cash flow statement that is prepared in accordance with IAS 7, "Cash Flow Statements," as amended. [Item 17(c)(2)(iii) of Form 20-F] A reconciliation of home country cash flow presentation to IAS 7 does not meet the requirements of the form.

2. Accounting for effects of hyperinflation

   a) A foreign private issuer that accounts in its primary financial statements for its operations in a hyperinflationary economy in accordance with IAS 21, "The Effects of Changes in Foreign Exchange Rates," as amended, may omit quantification of any differences that would have resulted from application of the U.S. standard, FAS 52. [Item 17(c)(2)(iv)(B) of Form 20-F]

   b) IAS 21 requires that amounts in the financial statements of the hyperinflationary operation be restated for the effects of changing prices in accordance with IAS 29, "Financial Reporting in Hyperinflationary Economies," and then translated to the reporting currency. The accommodation is only available if the issuer uses the historical cost/constant currency method of IAS 29. This accommodation relates to financial statements prepared in a stable reporting currency, not to financial statements price-level adjusted for inflation.
3. Certain differences involving business combinations

a) In certain circumstances, foreign issuers need not reconcile to U.S. GAAP certain differences attributable to the determination of the method of accounting for a business combination or for the amortization period of goodwill and negative goodwill, provided the financial statements comply with IAS 22, "Business Combinations," as amended (1993). These provisions are not available for business combinations that are promoter transactions, leveraged buyouts, mergers of entities under common control or reverse acquisitions.

(1) A business combination that qualifies as a uniting of interests under IAS 22 and which was accounted for using that method in the primary financial statements may be considered, for purposes of reconciliation to U.S. GAAP, a pooling of interests. 

NOTE: Since the requirements are very difficult to meet, business combinations rarely qualify as a uniting of interests under IAS 22. The staff should bring all transactions accounted for as a uniting of interests to the attention of DCAO.

(2) A business combination that qualifies as an acquisition under IAS 22 and which was accounted for using that method in the primary financial statements may be considered, for purposes of reconciliation to U.S. GAAP, a purchase.

b) The reconciliation should quantify differences resulting from applying the business combination method in the primary financial statements and the amounts determined in accordance with U.S. GAAP.

c) Foreign issuers need not reconcile to U.S. GAAP amounts arising from differences in the periods used to amortize goodwill and negative goodwill in the primary financial statements if the method used is consistently applied and consistent with IAS 22. [Item 17(c)(2)(viii)] In determining the amount of goodwill or negative goodwill that is subject to amortization for purposes of the reconciliation to U.S. GAAP, foreign private issuers would continue to be required to consider all other provisions of purchase accounting under U.S. GAAP.

d) IAS 22 was amended in 1998 to change certain requirements regarding the amortization of goodwill and negative goodwill. Ordinarily, the staff will extend the above accommodations to registrants using the 1998 version. However, the 1998 version permits certain treatments that were not contemplated when the original accommodation was adopted. Situations involving goodwill amortization periods greater than 20 years, and all situations involving negative goodwill, should be brought to the attention of DCAO to determine whether the accommodation is available.
4. Effects of proportional (pro rata) consolidation

a) Foreign private issuers that use proportional consolidation under home-country GAAP for investments in joint ventures that would be equity method investees under U.S. GAAP may omit reconciling differences related to classification or display and instead provide summarized footnote disclosure of the amounts proportionately consolidated, such as: [Item 17(c)(2)(vii) of Form 20-F]

- Current assets/liabilities
- Noncurrent assets/liabilities
- Net sales
- Gross profit
- Net income
- Cash flow information resulting from operating, financing, and investing activities

The disclosure should allow a reader to reconstruct a U.S. GAAP balance sheet. Summarized totals from the investee financial statements (rather than the amounts proportionally consolidated by the registrant) do not satisfy this condition.

NOTE: This accommodation for proportionately consolidated joint ventures only applies if:
- the joint venture is an operating entity and
- its significant financial operating policies are, by contractual arrangement, jointly controlled by all parties having an equity interest in the entity.

b) Separate financial statements of a joint venture being proportionally consolidated are not required.

V. Selection of a Reporting Currency

SX 3-20 allows a foreign private issuer to file financial statements prepared in any currency that management believes is appropriate.

A. Currency of Measurement

While there is free choice in the selection of the reporting currency, there is not free choice in the selection of the currency used for measurement. All operations, including those of the parent company, that do not operate in a hyperinflationary environment should be measured using the currency of the primary economic environment to measure transactions. While not specifically referring to FAS 52, SX 3-20 is designed to be conceptually consistent with that standard. Assets and liabilities are translated at the period end exchange rate and the income statement is
translated at the weighted average annual exchange rate. The translation effects of exchange rate changes are included as a separate component of equity.

**B. Disclosures, if the U.S. dollar is not the reporting currency:**

1. Currency used to prepare financial statements displayed prominently on the face of the financial statements.
2. Currency in which dividends are declared, if different from the reporting currency.
3. Description of material exchange restrictions or controls relating to the reporting currency, the currency of the issuer's domicile, or the currency in which the issuer will pay dividends.
4. Five-year history of exchange rates setting forth rates at period end, average, highs and lows. [Item 3.A of revised Form 20-F] The noon buying rate in New York City for cable transfers in foreign currencies as certified for customs purposes by the Federal Reserve Bank in New York can be obtained over the telephone or through the internet as follows:
   - Call (212) 720-6130 and ask for the Federal Reserve Bank certified noon buying rate for foreign currency cable transfers for the respective date and currency.
5. Dollar equivalent or convenience translations are generally not permitted, except that a convenience translation may be presented only of the most recent fiscal year and interim period. Translation should be made at the exchange rate on the balance sheet date or most recent date practicable, if materially different. The rate used for the convenience translation should generally be the rate that the issuer would use if dividends were to be paid in U.S. dollars.
6. An issuer filing a registration statement on Form F-2 or Form F-3 that incorporates financial statements previously filed on Form 20-F does not need to amend or otherwise modify these statements to reflect a more current exchange rate in presenting the convenience translation.

**NOTE:** Amendment or other modification is not necessary even if the company has presented a convenience translation on interim data in the registration statement or by reference to Form 6-K. In this situation, the issuer should disclose in the interim data that different exchange rates have been used for the convenience translation.

**C. Change in Reporting Currency**

1. Financial information for all periods presented in the filing should be recast into the new reporting currency using a methodology consistent with FAS 52. Income
statements should be translated from the old reporting currency into the new reporting currency using a weighted average exchange rate for the applicable period. The balance sheet should be translated using the applicable period end exchange rate. The objective of this procedure is to present financial statements as if the issuer had always used the new reporting currency.

2. If the reporting currency used in a registrant’s financial statements is different from that of its predecessor, the predecessor’s financial statements should be recast using the registrant’s reporting currency.

3. Use of the Euro as the reporting currency
   a) Foreign and domestic registrants that change their reporting currency to the Euro should prepare comparative financial statements for periods prior to the Euro’s introduction on January 1, 1999 by recasting previously reported financial statements into Euros using the January 1, 1999 fixed exchange rate between the Euro and the prior reporting currency. This method should not be used for a change to a reporting currency other than the Euro.

   NOTE: Investors may inappropriately assume that the financial statements of all registrants that report in Euros are directly comparable for periods prior to January 1, 1999. However, the underlying trends and relationships in those financial statements are based on legacy currency measurements and will not be comparable.

   b) To highlight the potential lack of comparability in periods prior to January 1, 1999, the registrant should include the disclosures outlined in EITF D-71.

VI. Price-level Adjusted Financial Statements and Effects of Hyperinflationary Environments

A. Requirements

1. An issuer in a hyperinflationary economy must either comprehensively include the effects of price-level changes in the primary statements or, alternatively, present supplemental information to quantify the effects of changing prices using the historical cost/constant currency or current cost/replacement cost approach. [SX 3-20 and 20-F Items 17 & 18(c)(2)(iv)] The quantified effects of applying price-level accounting are not eliminated in the reconciliation to U.S. GAAP. This provision applies to all issuers who price level adjust even if the currency of the primary economic environment is not hyperinflationary as defined under U.S. GAAP.
What is a hyperinflationary economy?

A hyperinflationary economy has cumulative inflation of approximately 100% or more over the most recent three-year period. See EITF D-55 for further guidance.

NOTE: Inflation rates are multiplied in computing cumulative inflation. For example, \(1.26 \times 1.26 \times 1.26 = 2.00\). Inflation of at least 26% for three years would result in cumulative inflation of 100%.

2. Issuers in a hyperinflationary economy that elect to report in accordance with U.S. GAAP can report in either the hyperinflationary currency or a stable currency.

<table>
<thead>
<tr>
<th>Reporting Currency Selected</th>
<th>Requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hyperinflationary currency</td>
<td>Present general price-level financial statements, as discussed in APB Statement 3, paragraph 26. [SOP 93-3, footnote 3]</td>
</tr>
<tr>
<td>Stable currency, such as the U.S. dollar</td>
<td>Apply the remeasurement principles of FAS 52. The stable currency’s average annual rate should be used for purposes of the income statement. [SX 3-20(c)]</td>
</tr>
</tbody>
</table>

B. Preparation of Price-level Adjusted Financial Statements

1. All price level adjusted financial information in a foreign private issuer’s registration statement should be presented in equivalent purchasing power units of the reporting currency. For each period presented, all measurements are retroactively restated to the purchasing power unit as of the date of the most recent balance sheet information in the filing.

2. If a company updates to include interim financial information, the prior annual financial information must be recast in equivalent purchasing power units. A company that incorporates by reference a prior annual report on Form 20-F need not amend the prior filing, but must file restated financial statements in the registration statement or under cover of a Form 6-K that is incorporated by reference.

3. If the rate of inflation during the interim period is very low such that the effect of restatement does not materially affect apparent trends and is clearly immaterial (for example, 3% or less), the staff has not insisted that prior period financial information be restated. If the information is not restated, the rate of inflation and the reason why restatement was not considered to be necessary should be disclosed.
4. If interim financial information more current than otherwise required by SEC rules is included in a registration statement solely to comply with Instruction 3 to Item 8.A.5 of revised Form 20-F, the staff encourages, but will not insist, that prior periods be restated. The staff expects companies to provide disclosure necessary to prevent the updated data from being misleading in relation to prior period financial information. For example, the registrant should provide supplemental selected financial data recast in equivalent purchasing power units, accompanied by disclosure of the rate of inflation that would be used to restate all prior financial information in equivalent purchasing power units.

   a) The cash flow statements of issuers that prepare price-level adjusted financial statements should present the effects of inflation on cash flows separately from their operating, investing and financing activities. The presentation of a “fourth” cash flow statement category, which separately captures these effects, meets this objective. Price-level adjusted cash flow statements that include the effects of inflation in the line items comprising the three major categories may make the presentation less meaningful and possibly misleading.

   Example of a potentially misleading presentation:
   The financing activities section of the cash flows statement, if price-level adjusted for inflation, may depict reductions of foreign-currency denominated debt because of the recasting of prior balance sheet amounts, even though no cash repayments may have actually occurred.

VII. Foreign Auditor Matters

   A. Qualifications and Independence

   1. In certain instances where the independent accountant is not licensed in the U.S. and not familiar to the staff, OCA may request information about the accountant's qualifications to practice before the Commission. Reports of unfamiliar foreign accountants should be brought to the attention of OCA via DCAO, who will advise of any procedures necessary to determine the acceptability of the foreign auditor's report.

   2. Auditors licensed outside the U.S. must comply with all requirements of Article 2 of Regulation S-X, including SEC rules on auditor independence.

   3. Auditors may be permitted or required by home-country regulations to render reports on the fairness or adequacy of consideration in an audit client’s planned merger or non-monetary transaction. These reports may violate U.S. independence rules. Instances should be brought to the attention of DCAO.
B. Reports

1. The report of the independent accountant, except for MJDS filers in Canada, should include a statement that the audit was conducted in accordance with U.S. GAAS. [Instruction 2 to Item 8.A.2 of revised Form 20-F; R33-7745]

2. The reconciliation to U.S. GAAP must be audited. The staff recommends that the report of the independent accountant refer explicitly to the reconciliation, but the absence of that reference does not relieve the auditor of its responsibility to examine the reconciliation. The reconciliation footnote may not be labeled "unaudited." Pursuant to Commission rules and auditing standards, omission of a material item required to reconcile the financial statements to U.S. GAAP pursuant to Item 17 or Item 18 of Form 20-F, or any otherwise inaccurate presentation of that reconciliation, would require a clear reference in the auditor's report identifying the omission or inaccuracy.

3. If the report includes reference to another accountant, the separate audit report and consent of that accountant must be included. Clarification in one of the reports as to which auditor is responsible for the reconciliation to U.S. GAAP may be necessary.

4. Some foreign private issuers or acquired foreign businesses are jointly audited by more than one firm. Both auditors sign the report and take full responsibility for the audit. Each auditor must comply fully with all requirements of Article 2 of Regulation S-X, including the U.S. independence requirements. In certain cases, one of the firms may be a U.S. firm.

5. Effective January 1, 2000, AICPA SEC Practice Section rules establish minimum requirements for the review of SEC filings by a designated “filing reviewer” within the independent accountant’s U.S. firm or international organization knowledgeable about U.S. GAAP, U.S. GAAS, U.S. auditor independence and SEC reporting requirements. Prior to commencing review of confidential filings, the staff requests written confirmation that the SECPS member firm’s review procedures were applied to the filing. We also request the name of the designated filing reviewer that the staff may contact with any questions concerning the application of those policies and procedures to the confidential filing. The purpose of the procedure is to ensure that foreign auditors appropriately involve their designated filing reviewer prior to submission of filings. The staff will consider deferring the review of a confidential filing where the application of the firm’s established policies and procedures to that filing cannot be confirmed.

C. Change in Accountant

Unlike Regulation S-K, Form 20-F does not require disclosure of changes in accountants. Foreign private issuers are not required to provide disclosure regarding a change in accountants in Exchange Act or Securities Act filings.

* * * * *
Topic Seven: RELATED PARTY MATTERS

I. General Disclosure Requirements
   [SX 1-02(u) and FAS 57]

   A. Definition of Related Party
      • Principal Owners: persons that hold 10% or more of the enterprise’s securities and their immediate families
      • Management: board of directors, executive officers and other persons with policy-making authority.
      • Affiliates: a party that directly or indirectly controls, is controlled by or is under common control with the enterprise. [SX 1-02(b)]
      • Investees accounted for by the equity method.
      • Employee trusts directed by management of the enterprise.
      • Entities, the management of which may be controlled or significantly influenced by the enterprise to the extent that it may be prevented from fully pursuing its own separate interests.
      • Parties who can influence significantly the enterprise.
      • Promoters: persons founding or organizing the entity; persons who receive 10% or more of the stock of the entity in connection with its founding or organization. [SX 1-02(s)]

   B. Disclosures
      1. All material related party transactions.
         a) The significance of an item may be independent of its amount; this is often the case with respect to related party transactions. [SAB 4E]
         b) No disclosure is required by FAS 57 for compensation arrangements, expense allowances and other similar items in the ordinary course of business.
      3. Description of transaction, including all information necessary for an understanding of its effects.
a) If material relative to total notes or accounts receivable, notes or accounts receivable from related parties should be shown separately. [SAB 4E] Dollar amounts of all material related party transactions should be disclosed in the notes.

b) SX 4-08(k) requires the dollar amount of related party transactions be disclosed on the face of the balance sheet, income statement, or statement of cash flows, as appropriate. However, the staff may accept footnote disclosure if, giving consideration to the magnitude and nature of the transaction and the relationship of the parties, prominent display on the face is not warranted.

c) FAS 57 requires that terms and manner of settlement of amounts due to/from related parties be disclosed unless they are otherwise apparent.

4. Transactions should not be represented in the financial statements as equivalent to arm’s length transactions unless that statement can be substantiated.

5. Forgiveness of debt by a related party typically should be considered a capital transaction. [footnote 1, APB 26.20]

II. Expenses Incurred on Behalf of Registrant

A. Reflect All Costs of Doing Business in the Financial Statements [SAB 1B.1 and 5T]

All costs of doing business, including costs incurred by parent and others, should be reflected in historical financial statements. Allocation of common expenses may be required. Footnote disclosure should include management’s assertion that the allocation method is reasonable and management’s estimate of what the expenses would have been on a stand-alone basis, if materially different. See also Section IV, “Components of Larger Entities,” below.

1. Organizational and offering costs paid for by a related party should be reflected in the financial statements of the registrant where those costs will be directly or indirectly reimbursed. [SAB 5D] In the absence of an obligation or intent to reimburse directly or indirectly, the staff will not insist on inclusion of these amounts in the issuer’s financial statements.

2. Obligations paid by parent or principal shareholder on behalf of the registrant must be reflected in the registrant’s financial statements. [SAB 5T]

B. Compensation Arrangements

1. Contributed services

   a) Historical financial statements should reflect reasonable compensation levels. Where charges were not made or are unreasonably low, and if material to an understanding of operating results, historical statements should be revised to reflect the value of services rendered as a capital contribution. However,
contributed services ordinarily need not be reflected if the entity is in formation or earliest phases of development stage.

b) If historical statements reflect compensation that is not unreasonable, but is materially different from that after the offering, disclosure of the salary commitment should be made and pro forma data for the latest year and interim period may be necessary. [SAB 2C]

2. Employee stock plans and other compensation provided by the parent or promoter should be reflected in registrant’s financial statements. [AIN-APB 25,#1]

III. Transfers and Receivables from Shareholders
[SAB 5G]

A. Transfer of Nonmonetary Assets
In most circumstances, transfers of nonmonetary assets for stock or other consideration of the registrant prior to an initial public offering are recorded at predecessor cost as determined in accordance with GAAP. Where the registrant gives monetary consideration for property conveyed by promoters, the excess over predecessor cost is treated as a reduction of equity (i.e., a special distribution).

NOTE: The guidance in SAB 5G is not intended to modify the requirements of APB Opinion No. 16. The combination of two or more businesses should be accounted for in accordance with APB Opinion No. 16 and its interpretations and SAB 2A.

B. Receivables
1. Receivables from affiliates which are the equivalent of unpaid subscriptions receivable or capital distributions should be reflected as a deduction from equity. [SAB 4G]
2. Receivables arising in the ordinary course of business and paid in the ordinary business cycle need not be deducted from equity. [SAB 4E]

C. Distributions to Major Shareholders Prior to Offering [SAB 1B(3)]
1. Refer to Topic Three for detailed discussion of pro forma requirements
2. Distributions should be given retroactive effect in latest balance sheet or reflected in pro forma balance sheet along side of historical balance sheet.
3. If the distribution is compensation for prior services or consideration for prior conveyances, only retroactive presentation would be acceptable.
D. Offering Proceeds

1. If a material portion of the proceeds of an offering will be distributed to shareholders, present pro forma EPS for the latest year and interim period giving effect to the number of shares whose proceeds will be used to pay dividends in addition to historical EPS.

2. Even if the distribution is not clearly to be paid from offering proceeds, pro forma EPS is required if distribution exceeds current year’s earnings.

IV. Components of Larger Entities

[SAB 1B]

A. Financial Statement Requirements

The financial statements of components of larger entities should consider the following:

1. All costs of doing business should be included in registrant’s financial statements, including expenses incurred on its behalf by its parent or other shareholders.

2. Reasonable method of expense allocation should be applied where specific identification is not practicable; accompanied by footnote explanation, management’s assertion that method is reasonable, and disclosure of what expenses would have been on stand-alone basis.

3. If historical cost-sharing is not continued, present pro forma EPS data for latest year and interim period only.

4. Tax expense is presented, preferably, on stand-alone basis in historical financial statements. (Pro forma may be an alternative.)

5. Interest expense associated with debt “pushed down” to the registrant’s books or to be paid with offering proceeds should be reflected in historical statements. Also, parent’s debt secured by registrant’s assets should be reflected in registrant’s financial statements. [SAB 5J] Where other interest expense on intercompany debt is not included, an analysis of intercompany accounts as well as average balances should be provided for each period.

6. Retained earnings should not be separately reported by a non-corporate entity. The residual interest should be presented as a single component, such as “parent’s equity in division”.

7. Push-down accounting of the parent’s basis, including goodwill, if any, should be reflected in the entity’s financial statements. This applies even where the parent is an individual or control group of individuals. [SAB 5J]

   a) The staff will not object to the application of push down accounting if the parent acquires 80 to 95% of a subsidiary.
b) Push down is required at the 95% and above level, unless the entity has outstanding public debt, and is not permitted if less than 80% of a subsidiary is acquired.

c) If a subsidiary without public debt becomes 95% owned by the parent or public debt is eliminated from a 95%-owned entity’s financial statements in a subsequent period, the entity’s financial statements must be adjusted at that time to push down the parent’s basis. Also see EITF No. 90-5 for push down of parent’s cost in a transfer of an equity interest in one subsidiary to another controlled subsidiary.

B. Statements of Revenues and Direct Expenses

Refer to Topic Two, Section I.A.3 for a discussion of when less than full financial statements are appropriate as well as form and content requirements.

C. Pro Forma Financial Statement Requirements

Refer to Topic Three, Section II.K for guidance on pro forma financial information related to acquisitions of components of larger entities.

V. Research & Development Arrangements

[FAS 68]

A presumption exists that the registrant will pay back the funding party (i.e., a liability should be recorded) where 10% or more of the funding party is owned by persons deemed to be related parties of the registrant, or where the funding party has any direct interest in the registrant. The apparent absence of financial ability to pay funding party back does not overcome this presumption. [SAB 50]

VI. Compensation Issues

A. Stock Compensation

1. Compensatory stock, options or warrants issued to

   a) employees are accounted for under APB 25 or FAS 123.

   b) non-employees, including consultants, advisory board members or others providing services to the issuer are accounted for under FAS 123. See also EITF No. 96-18.

2. In evaluating whether a stock issuance is in fact a compensation arrangement or only a restructuring of non-employee ownership rights prior to an offering, the staff will evaluate the circumstances of the issuance and the extent of employee participation.
B. Cheap Stock

1. Measurement

Under paragraph 10 of APB 25, the fair value of the company’s stock on the measurement date must be used to measure compensation. In the evaluation of the fair value of the stock, the registrant should consider the proximity of the issuance to the offering, intervening events, transfer restrictions and exercise dates, and profitability and financial condition of the company. The staff looks to objective evidence as the best support for the determination of market value. Examples of objective evidence include transactions with third parties involving issuances or repurchases of stock for cash (including the offering) and/or appraisals by reputable valuation experts independent of the offering at or near the issue date.

2. Cheap Stock vs Nominal Issuances

Issuances for which compensation or other expense has been appropriately recorded under APB 25 or FAS 123 ordinarily would not be considered nominal issuances since consideration received for issuance of shares may include goods or services. However, even if goods or services are received, it may still be necessary to compare the consideration received, as accounted for in the financial statements, to the fair value of the shares issued to determine whether the consideration is nominal. Also, issuances in exchange for assets (e.g., SAB 48 transactions) would not be considered nominal issuances, unless the fair value of the assets is nominal.

3. The staff expects nominal issuances to be limited to certain issuances to investors or promoters. Any issuances considered to be nominal should be brought to the attention of DCAO.

C. Escrowed Shares

The staff views the placement of shares in escrow as a recapitalization by promoters similar to a reverse stock split. The agreement to release the shares upon the achievement of certain criteria is presumed by the staff to be a separate compensatory arrangement between the registrant and the promoters. Accordingly, the fair value of the shares at the time they are released from escrow should be recognized as a charge to income in that period. However, no compensation expense need be recognized for shares released to a person that has had no relationship to the registrant other than as a shareholder (for example, is not an officer, director, employee, consultant or contractor), and that is not expected to have any other relationship to the company in the future.

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8/9/2001
Topic Eight: NON-GAAP MEASURES OF FINANCIAL PERFORMANCE, LIQUIDITY AND NET WORTH

I. Disclosure of Non-GAAP Measures Such as Earnings Before Interest, Taxes, Depreciation and Amortization (“EBITDA”)

A. Common Problems and General Guidelines

While it may be required under FAS 131 for some registrants to disclose in a note to the financial statements and discuss in MD&A a non-GAAP measure related to its operating segments (see Section B below), some registrants choose to present a non-GAAP financial measure such as EBITDA or FFO (funds from operations) in their disclosure documents. Although such measures can be useful in some circumstances, an unbalanced presentation can be confusing and lead to undue reliance on the measure by investors. Problems associated with presentations of non-GAAP measures were highlighted by the Commission in Accounting Series Release No. 142. Some comments cited frequently by the staff include the following:

1. Undue authority or prominence

   A non-GAAP measure should be presented in a manner that does not give it greater authority or prominence than conventionally computed earnings or cash flows as reported in the GAAP financial statements. For example, the staff recommends that EBITDA and similar measures be located within an “other data” section in selected financial data. Discussions in MD&A of results as measured in the GAAP financial statements should be no less complete than discussions of performance or liquidity as depicted by non-GAAP measures.

2. Measures not comparable

   Wherever the non-GAAP measure is used, a footnote or other reference to a complete explanation of its calculation and components should be provided. Since all companies and analysts do not calculate these non-GAAP measures in the same fashion, the staff recommends that the footnote or other disclosure alert investors to the fact that the measure presented may not be comparable to similarly titled measures reported by other companies.
3. How measures are used by management and investors

Management should consider how any non-GAAP measure is expected to be used by investors, identify significant factors that should be considered, and discuss significant trends or requirements not captured by the measure to ensure balance and avoid undue reliance on the measure. Notwithstanding disclosures by competitors or requests from financial analysts, the staff believes that most non-GAAP measures generally should be avoided unless management itself believes that the measure provides relevant and useful information.

4. Balanced presentation

Non-GAAP measures that measure cash or “funds” generated by operations (liquidity) should be balanced with equally prominent disclosure of amounts from the statement of cash flows (cash flows from operating, investing and financing activities) and, in some cases, the ratio or deficiency of earnings to fixed charges. Explanation may be necessary to the extent that funds depicted by the measure are not available for management’s discretionary use (due to legal or functional requirements to conserve funds for capital replacement and expansion, debt service and balloon maturities, deferred interest and dividend payments, and other commitments and uncertainties).

5. Measure of operating performance vs. measure of liquidity

A frequent disclosure issue is the use of a non-GAAP measure in a discussion of operating performance when the measure is primarily a measure of liquidity, capital resources, or debt service capacity. For example, calculations that depict an adjusted or normalized measure of working capital or funds generated by operations and available to meet capital and debt requirements often are presented inappropriately as if they should be used as alternative measures of earnings, return on investment or similar performance or efficiency factors. In that case, the staff will request the measure’s presentation in an appropriate context with clarification of its expected use.
6. Pro forma measure of performance

If management is presenting the non-GAAP calculation as an alternative or pro forma measure of performance, the staff discourages adjustments to eliminate or smooth items characterized as nonrecurring, infrequent or unusual. Different unusual items are likely to occur every period, and companies and investors may differ as to what types of events warrant adjustment. Trends may be distorted and disclosure unbalanced if only certain items are adjusted while the effects of other infrequent events or transactions (whether favorable or unfavorable) are not considered or highlighted. Of course, all such special items should be highlighted in the registrant’s disclosures to permit analysis by investors. Where management intends the measure to be indicative of liquidity and communicates that use through the context of its presentation, the staff ordinarily will not object to adjustment for non-cash charges relating to special items if it is meaningful to investors in the circumstances.

7. Per share presentation

Per share data other than that relating to net income is not appropriate.

8. Location of presentation

Presentation and discussion of non-GAAP measures should be limited to selected and summary financial data, MD&A and notes to pro forma information. Presentation of non-GAAP measures is not appropriate on the face of the audited financial statements or on the face of SX Article 11 pro forma information.

B. Segment Analysis and Non-GAAP Measures

Where consistent with a registrant’s internal management reports, FAS 131 permits measures of segment profitability that differ from consolidated operating profit as defined by GAAP, or that exclude items included in the determination of the registrant’s net income. Under FAS 131, a registrant also must reconcile key segment amounts to the corresponding items reported in the consolidated financial statements in a note to the financial statements. Similarly, the staff expects that the discussion of a segment whose profitability is determined on a basis that differs from consolidated operating profit as defined by GAAP or that excludes the effects of items attributable to the segment also will address the applicable reconciling items in MD&A. Likewise, the staff expects that the effects of management’s use of non-GAAP measures, either on a consolidated or segment basis, will be explained in a balanced and informative manner, and the disclosure will include a discussion of how that segment’s performance has affected the registrant’s GAAP financial statements.
II. Ratio of Earnings to Fixed Charges

[SK 503]

A. Required disclosure

If debt securities are being registered, a ratio of earnings to fixed charges shall be presented. If preference equity securities are being registered, a ratio of earnings to combined fixed charges and preference security dividend requirements shall be presented. The ratios shall be presented for each of the last five fiscal years and the latest interim period for which financial statements are presented.

B. Definition of fixed charges

For purposes of the ratios, fixed charges are defined as the sum of interest, whether expensed or capitalized, amortization of premiums, discounts and capitalized expenses related to indebtedness, amounts accrued with respect to guarantees of other parties’ obligations, and the estimated interest component of rental expense.

C. Dividend requirements

Preference security dividend requirements for purposes of the ratio are intended to represent the amount of pre-tax earnings that would be required to pay the dividends on outstanding preference securities of the registrant and other fully or proportionally consolidated entities. The amount shall be computed as the dividend requirement divided by (1 - income tax rate).

D. Definition of earnings

For purposes of the ratio, earnings are defined as the registrant’s income from continuing operations before taxes as determined in accordance with GAAP, except that only distributed earnings of less than 50%-owned equity investees are included, plus fixed charges reduced by the amounts of capitalized interest, plus income allocable to minority interests in consolidated entities that have incurred fixed charges.

E. Equity in investee’s losses

Losses from investees that are not fully or proportionally consolidated by the registrant may not be added back to earnings for purposes of the ratio, unless the registrant is obligated directly or indirectly to service the debt, dividend requirements, or rental obligations of the investee. If the registrant is so obligated, its equity in the investee’s loss shall be included in earnings, and fixed charges shall include the investee’s fixed charges that are related to the obligation.
F. Inadequate earnings to cover fixed charges  
If a ratio indicates less than one-to-one coverage, the registrant shall state that earnings are inadequate to cover fixed charges and disclose the dollar amount of the coverage deficiency.

G. Pro forma effect of refinancing  
If proceeds from the sale of the debt or preferred stock being registered will be used to extinguish a portion or all of one or more specific issues of outstanding debt or preferred stock, a pro forma ratio depicting the effect of the refinancing shall be presented if the change in the ratio would be ten percent or greater. The adjustments to derive the pro forma ratio shall be limited to the net change in interest or dividends resulting from the refinancing. If only a portion of the proceeds will be used to retire debt or preferred stock, only a related portion of the interest or preferred dividend should be used in the pro forma adjustment. The pro forma ratio shall be presented for the latest year and interim period only.

H. Foreign private issuer  
If the registrant is a foreign private issuer, the ratio shall be computed on the basis of the primary financial statements and, if materially different, on a U.S. GAAP basis

I. Exhibit 12  
Calculations demonstrating the determination of the ratios shall be furnished as an exhibit to the registration statement

III. Tangible Book Value per Share  
There are no rules or authoritative guidelines that define tangible book value. Tangible book value per share is used generally as a conservative measure of net worth, approximating liquidation value. The staff believes generally that tangible assets should exclude any intangible asset (such as deferred costs or goodwill) that cannot be sold separately from all other assets of the business, and should exclude any other intangible asset for which recovery of book value is subject to significant uncertainty or illiquidity.

In some cases, the staff accepts dual calculations of tangible book value. For example, some intangible assets (such as patents) may be sold separately, but the ability to recover their carrying value may be indeterminable. Also, some material deferred costs are accounted for as adjustments to the yield on specific assets or liabilities (debt costs or policy acquisition costs). The staff has accepted tangible book value per share calculations made with and without those assets, with appropriate explanation.

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