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### Topic 13: Revenue Recognition

- A. Selected Revenue Recognition Issues
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### Topic 1: Financial Statements

#### A. Target Companies

*Facts:* Company X proposes to file a registration statement covering an exchange offer to stockholders of Company Y, a publicly held company. Company X asks Company Y to furnish information about its business, including current audited financial statements, for inclusion in the prospectus. Company Y declines to furnish such information.

*Question 1:* In filing the registration statement without the required information about Company Y, may Company X rely on Rule 409 in that the information is “unknown or not reasonably available?”

*Interpretive Response:* Yes, but to determine whether such reliance is justified, the staff requests the registrant to submit as supplemental information copies of correspondence between the registrant and the target company evidencing the request for and the refusal to furnish the financial statements. In addition, the prospectus must include any financial statements which are relevant and available from the Commission’s public files and must contain a statement adequately describing the situation and the sources of information about the target company. Other reliable sources of financial information should also be utilized.

*Question 2:* Would the response change if Company Y was a closely held company?

*Interpretive Response:* Yes. The staff does not believe that Rule 409 is applicable to negotiated transactions of this type.

#### B. Allocation of Expenses and Related Disclosure in Financial Statements of Subsidiaries, Divisions or Lesser Business Components of Another Entity

*Facts:* A company (the registrant) operates as a subsidiary of another company (parent). Certain expenses incurred by the parent on behalf of the subsidiary have not been charged to the subsidiary in the past. The subsidiary files a registration statement under the Securities Act of 1933 in connection with an initial public offering.

#### 1. Costs Reflected in Historical Financial Statements

*Question 1:* Should the subsidiary’s historical income statements reflect all of the expenses that the parent incurred on its behalf?

*Interpretive Response:* In general, the staff believes that the historical income statements of a registrant should reflect all of its costs of doing business. Therefore, in specific situations, the staff has required the subsidiary to revise its financial statements to include certain expenses incurred by the parent on its behalf. Examples of such expenses may include, but are not necessarily limited to, the following (income taxes and interest are discussed separately below):

- 1. Officer and employee salaries,
- 2. Rent or depreciation,
- 3. Advertising,
- 4. Accounting and legal services, and
- 5. Other selling, general and administrative expenses.

When the subsidiary’s financial statements have been previously reported on by independent accountants and have been used other than for internal purposes, the staff has accepted a presentation that shows income before tax as previously reported, followed by adjustments for expenses not previously allocated, income taxes, and adjusted net income.

*Question 2:* How should the amount of expenses incurred on the subsidiary’s behalf by its parent be determined, and what disclosure is required in the financial statements?

*Interpretive Response:* The staff expects any expenses clearly applicable to the subsidiary to be reflected in its income statements. However, the staff understands that in some situations a reasonable method of allocating common expenses to the subsidiary (e.g., incremental or proportional cost allocation) must be chosen because specific identification of expenses is not practicable. In these situations, the staff has required an explanation of the allocation method used in the notes to the financial statements along with

management’s assertion that the method used is reasonable.

In addition, since agreements with related parties are by definition not at arms length and may be changed at any time, the staff has required footnote disclosure, when practicable, of management’s estimate of what the expenses (other than income taxes and interest discussed separately below) would have been on a stand alone basis, that is, the cost that would have been incurred if the subsidiary had operated as an unaffiliated entity. The disclosure has been presented for each year for which an income statement was required when such basis produced materially different results.

*Question 3:* What are the staff’s views with respect to the accounting for and disclosure of the subsidiary’s income tax expense?

*Interpretive Response:* Recently, a number of parent companies have sold interests in subsidiaries, but have retained sufficient ownership interests to permit continued inclusion of the subsidiaries in their consolidated tax returns. The staff believes that it is material to investors to know what the effect on income would have been if the registrant had not been eligible to be included in a consolidated income tax return with its parent. Some of these subsidiaries have calculated their tax provision on the separate return basis, which the staff believes is the preferable method. Others, however, have used different allocation methods. When the historical income statements in the filing do not reflect the tax provision on the separate return basis, the staff has required a pro forma income statement for the most recent year and interim period reflecting a tax provision calculated on the separate return basis.<sup>1</sup>

*Question 4:* Should the historical income statements reflect a charge for interest on intercompany debt if no such charge had been previously provided?

*Interpretive Response:* The staff generally believes that financial statements are more useful to investors if they reflect all costs of doing business, including interest costs. Because of the inherent difficulty in distinguishing the elements of a subsidiary’s capital structure, the staff has not insisted that

<sup>1</sup> Paragraph 40 of Statement 109 states: “The consolidated amount of current and deferred tax expense for a group that files a consolidated tax return shall be allocated among the members of the group when those members issue separate financial statements. \* \* \* The method adopted \* \* \* shall be systematic, rational, and consistent with the broad principles established by [Statement 109]. A method that allocates current and deferred taxes to members of the group by applying [Statement 109] to each member as if it were a separate taxpayer meets those criteria.”