

**Question 3:** Company A borrows funds to acquire substantially all of the common stock of Company B. Company B subsequently files a registration statement in connection with a public offering of its stock or debt.<sup>2</sup> Should Company B's new basis ("push down") financial statements include Company A's debt related to its purchase of Company B?

**Interpretive Response:** The staff believes that Company A's debt,<sup>3</sup> related interest expense, and allocable debt issue costs should be reflected in Company B's financial statements included in the public offering (or an initial registration under the Exchange Act) if: (1) Company B is to assume the debt of Company A, either presently or in a planned transaction in the future; (2) the proceeds of a debt or equity offering of Company B will be used to retire all or a part of Company A's debt; or (3) Company B guarantees or pledges its assets as collateral for Company A's debt.

Other relationships may exist between Company A and Company B, such as the pledge of Company B's stock as collateral for Company A's debt.<sup>4</sup> While in this latter situation, it may be clear that Company B's cash flows will service all or part of Company A's debt, the staff does not insist that the debt be reflected in Company B's financial statements providing there is full and prominent disclosure of the relationship between Companies A and B and the actual or potential cash flow commitment. In this regard, the staff believes that Statements 5 and 57 as well as Interpretation 45 require sufficient disclosure to allow users of Company B's financial statements to fully understand the impact of the relationship on Company B's present and future cash flows. Rule 4-08(e) of Regulation S-X also requires disclosure of restrictions which limit the payment of dividends. Therefore, the staff believes that the equity section of Company B's balance sheet and any pro forma financial information and

capitalization tables should clearly disclose that this arrangement exists.<sup>5</sup>

Regardless of whether the debt is reflected in Company B's financial statements, the notes to Company B's financial statements should generally disclose, at a minimum: (1) The relationship between Company A and Company B; (2) a description of any arrangements that result in Company B's guarantee, pledge of assets<sup>6</sup> or stock, etc. that provides security for Company A's debt; (3) the extent (in the aggregate and for each of the five years subsequent to the date of the latest balance sheet presented) to which Company A is dependent on Company B's cash flows to service its debt and the method by which this will occur; and (4) the impact of such cash flows on Company B's ability to pay dividends or other amounts to holders of its securities.

Additionally, the staff believes Company B's Management's Discussion and Analysis of Financial Condition and Results of Operations should discuss any material impact of its servicing of Company A's debt on its own liquidity pursuant to Item 303(a)(1) of Regulation S-K.

#### *K. Deleted by SAB 95*

##### *L. LIFO Inventory Practices*

**Facts:** On November 30, 1984, AcSEC and its Task Force on LIFO Inventory Problems (task force) issued a paper, "Identification and Discussion of Certain Financial Accounting and Reporting Issues Concerning LIFO Inventories." This paper identifies and discusses certain financial accounting and reporting issues related to the last-in, first-out (LIFO) inventory method for which authoritative accounting literature presently provides no definitive guidance. For some issues, the task force's advisory conclusions recommend changes in current practice to narrow the diversity which the task force believes exists. For other issues, the task force's advisory conclusions recommend that current practice should be continued for financial reporting purposes and that additional accounting

guidance is unnecessary. Except as otherwise noted in the paper, AcSEC generally supports the task force's advisory conclusions. As stated in the issues paper, "Issues papers of the AICPA's accounting standards division are developed primarily to identify financial accounting and reporting issues the division believes need to be addressed or clarified by the Financial Accounting Standards Board." On February 6, 1985, the FASB decided not to add to its agenda a narrow project on the subject of LIFO inventory practices.

**Question 1:** What is the SEC staff's position on the issues paper?

**Interpretive Response:** In the absence of existing authoritative literature on LIFO accounting, the staff believes that registrants and their independent accountants should look to the paper for guidance in determining what constitutes acceptable LIFO accounting practice.<sup>1</sup> In this connection, the staff considers the paper to be an accumulation of existing acceptable LIFO accounting practices which does not establish any new standards and does not diverge from GAAP.

The staff also believes that the advisory conclusions recommended in the issues paper are generally consistent with conclusions previously expressed by the Commission, such as:

1. Pooling—paragraph 4-6 of the paper discusses LIFO inventory pooling and concludes "establishing separate pools with the principal objective of facilitating inventory liquidations is unacceptable." In Accounting and Auditing Enforcement Release 35, August 13, 1984, the Commission stated that it believes that the Company improperly realigned its LIFO pools in such a way as to maximize the likelihood and magnitude of LIFO liquidations and thus, overstated net income.

2. New Items—paragraph 4-27 of the paper discusses determination of the cost of new items and concludes "if the double extension or an index technique is used, the objective of LIFO is

<sup>2</sup> The guidance in this SAB should also be considered for Company B's separate financial statements included in its public offering following Company B's spin-off or carve-out from Company A.

<sup>3</sup> The guidance in this SAB should also be considered where Company A has financed the acquisition of Company B through the issuance of mandatory redeemable preferred stock.

<sup>4</sup> The staff does not believe Company B's financial statements must reflect the debt in this situation because in the event of default on the debt by Company A, the debt holder(s) would only be entitled to B's stock held by Company A. Other equity or debt holders of Company B would retain their priority with respect to the net assets of Company B.

<sup>5</sup> For example, the staff has noted that certain registrants have indicated on the face of such financial statements (as part of the stockholder's equity section) the actual or potential financing arrangement and the registrant's intent to pay dividends to satisfy its parent's debt service requirements. The staff believes such disclosures are useful to highlight the existence of arrangements that could result in the use of Company B's cash to service Company A's debt.

<sup>6</sup> A material asset pledge should be clearly indicated on the face of the balance sheet. For example, if all or substantially all of the assets are pledged, the "assets" and "total assets" captions should include parenthetically: "pledged for parent company debt—See Note X."

<sup>1</sup> In ASR 293 (July 2, 1981) see Financial Reporting Codification § 205, the Commission expressed its concerns about the inappropriate use of Internal Revenue Service (IRS) LIFO practices for financial statement preparation. Because the IRS amended its regulations concerning the LIFO conformity rule on January 13, 1981, allowing companies to apply LIFO differently for financial reporting purposes than for tax purposes, the Commission strongly encouraged registrants and their independent accountants to examine their financial reporting LIFO practices. In that release, the Commission acknowledged the "task force which has been established by AcSEC to accumulate information about [LIFO] application problems" and noted that "This type of effort, in addition to self-examination [of LIFO practices] by individual registrants, is appropriate \* \* \*