

establishes or finances a stock option, purchase or award plan for one or more employees of the company.

Interpretation 1 states that "if a principal stockholder's intention is to enhance or maintain the value of his investment by entering into such an arrangement, the corporation is implicitly benefiting from the plan by retention of, and possibly improved performance by, the employee. In this case, the benefits to a principal stockholder and to the corporation are generally impossible to separate. Similarly, it is virtually impossible to separate a principal stockholder's personal satisfaction from the benefit to the corporation." As a result, Interpretation 1 requires the company to account for such a transaction as if it were a compensatory plan adopted by the company, with an offsetting contribution to capital, unless: (1) The stockholder's relationship to the employee would normally result in generosity, (2) the stockholder has an obligation to the employee which is unrelated to employment, or (3) the company clearly does not benefit from the transaction.

The staff believes that the problem of separating the benefit to the principal stockholder from the benefit to the company cited in Interpretation 1 is not limited to transactions involving stock compensation. Therefore, similar accounting is required in this and other² transactions where a principal stockholder pays an expense for the company, unless the stockholder's action is caused by a relationship or obligation completely unrelated to his position as a stockholder or such action clearly does not benefit the company.

Some registrants and their accountants have taken the position that since Statement 57 applies to these transactions and requires only the disclosure of material related party transactions, the staff should not require the accounting called for by Interpretation 1 for transactions other than those specifically covered by it. The staff notes, however, that Statement 57 does not address the measurement of related party transactions and that, as a result, such transactions are generally recorded at the amounts indicated by their terms.³ However, the staff believes

that transactions of the type described above differ from the typical related party transactions.

The transactions for which Statement 57 requires disclosure generally are those in which a company receives goods or services directly from, or provides goods or services directly to, a related party, and the form and terms of such transactions may be structured to produce either a direct or indirect benefit to the related party. The participation of a related party in such a transaction negates the presumption that transactions reflected in the financial statements have been consummated at arm's length. Disclosure is therefore required to compensate for the fact that, due to the related party's involvement, the terms of the transaction may produce an accounting measurement for which a more faithful measurement may not be determinable.

However, transactions of the type discussed in the facts given do not have such problems of measurement and appear to be transacted to provide a benefit to the stockholder through the enhancement or maintenance of the value of the stockholder's investment. The staff believes that the substance of such transactions is the payment of an expense of the company through contributions by the stockholder. Therefore, the staff determined that it was inappropriate to permit accounting according to the form of the transaction.

U. Gain Recognition on the Sale of A Business or Operating Assets to A Highly Leveraged Entity

Facts: A registrant has sold a subsidiary, division or operating assets to a newly formed, thinly capitalized, highly leveraged entity (NEWCO) for cash or a combination of cash and securities, which may include subordinated debt, preferred stock, warrants, options or other instruments issued by NEWCO. In some of these transactions, registrants may guarantee debt or enter into other agreements (sometimes referred to as make-well agreements) that may require the registrant to infuse cash into NEWCO under certain circumstances. Securities received in the transaction are not actively traded and are subordinate to

statements or a pro forma presentation (depending on the circumstances), related party transactions at amounts other than those indicated by their terms. Two such circumstances are addressed in Staff Accounting Bulletin Topic 1.B.1, Questions 3 and 4. Another example is where the terms of a material contract with a related party are expected to change upon the completion of an offering (*i.e.*, the principal shareholder requires payment for services which had previously been contributed by the shareholder to the company)

substantially all of NEWCO's other debt. The value of the consideration received appears to exceed the cost basis of the net assets sold.

Question 1: Assuming the transaction may be properly accounted for as a divestiture,¹ does the staff believe it is appropriate for the registrant to recognize a gain?

Interpretive Response: The staff believes there often exist significant uncertainties about the seller's ability to realize non-cash proceeds received in transactions in which the purchaser is a thinly capitalized, highly leveraged entity, particularly when its assets consist principally of those purchased from the seller. The staff believes that such uncertainties raise doubt as to whether immediate gain recognition is appropriate. Factors that may lead the staff to question gain recognition in such transactions include:

1. Situations in which the assets or operations sold have historically not produced cash flows from operations² that will be sufficient to fund future debt service and full dividend requirements on a current basis.³ Often the servicing of debt and preferred dividend requirements is dependent upon future events that cannot be assured, such as sales of assets or improvements in earnings.

2. The lack of any substantial amount of equity capital in NEWCO other than that provided by the registrant; and/or

3. The existence of contingent liabilities of the registrant, such as debt guarantees or agreements that require

¹ Transactions such as these require careful evaluation to determine whether, in substance, a divestiture has occurred. SAB Topic 5.E provides the staff's views on circumstances that may exist that would lead the staff to conclude that the risks of the business have not been transferred to the new owners and that a divestiture has not occurred. Topic 5.E indicates that factors to consider in determining whether a transaction should be accounted for as a divestiture include:

- Continuing involvement by the seller in the business;
- Absence of a significant financial investment in the business by the buyer;
- Repayment of debt, which constitutes the principal consideration in the transaction, is dependent on future successful operations; or
- The continued necessity for debt or contract performance guarantees on behalf of the business by the seller.

Further, the seller should consider whether it is required to consolidate the entity by way of its variable interests held in the NEWCO pursuant to the provisions of FASB Interpretation 46.

² As defined in paragraphs 21–24 of Statement 95.

³ The ability of NEWCO to fund the debt service and the dividend requirement(s) should be evaluated on a full accrual basis—*i.e.*, irrespective of the purchaser's ability to satisfy those requirements through deferral (contractually or otherwise) of any required cash payments or the issuance of additional securities to satisfy such requirements.

² For example, SAB Topic 1.B indicates that the separate financial statements of a subsidiary should reflect any costs of its operations which are incurred by the parent on its behalf. Additionally, the staff notes that AICPA Technical Practice Aids § 4160 also indicates that the payment by principal stockholders of a company's debt should be accounted for as a capital contribution.

³ However, in some circumstances it is necessary to reflect, either in the historical financial