

through rates that do not meet the criteria of paragraph 9 should not be recognized either as an asset or as a reduction of the probable liability.

**Question 2:** May a rate-regulated enterprise delay recognition of a probable and estimable liability for environmental costs which it has incurred at the date of the latest balance sheet until the regulator's deliberations have proceeded to a point enabling management to determine whether this cost is likely to be included in allowable costs for rate-making purposes?

**Interpretive Response:** No. Statement 5 states that an estimated loss from a loss contingency shall be accrued by a charge to income if it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated.<sup>2</sup> The staff believes that actions of a regulator can affect whether an incurred cost is capitalized or expensed pursuant to Statement 71, but the regulator's actions cannot affect the timing of the recognition of the liability.

#### Topic 11: Miscellaneous Disclosure

##### A. Operating-Differential Subsidies

**Facts:** Company A has received an operating-differential subsidy pursuant to the Merchant Marine Act of 1936, as amended.

**Question:** How should such subsidies be displayed in the income statement?

**Interpretive Response:** Revenue representing an operating-differential subsidy under the Merchant Marine Act of 1936, as amended, must be set forth as a separate line item in the income statement either under a revenue caption or as credit in the costs and expenses section.

##### B. Depreciation and Depletion Excluded From Cost of Sales

**Facts:** Company B excludes depreciation and depletion from cost of sales in its income statement.

**Question:** How should this exclusion be disclosed?

**Interpretive Response:** If cost of sales or operating expenses exclude charges for depreciation, depletion and amortization of property, plant and equipment, the description of the line item should read somewhat as follows: "Cost of goods sold (exclusive of items shown separately below)" or "Cost of goods sold (exclusive of depreciation shown separately below)." To avoid placing undue emphasis on "cash flow," depreciation, depletion and amortization should not be positioned in the income statement in a manner

which results in reporting a figure for income before depreciation.

##### C. Tax Holidays

**Facts:** Company C conducts business in a foreign jurisdiction which attracts industry by granting a "holiday" from income taxes for a specified period.

**Question:** Does the staff generally request disclosure of this fact?

**Interpretive Response:** Yes. In such event, a note must (1) disclose the aggregate dollar and per share effects of the tax holiday and (2) briefly describe the factual circumstances including the date on which the special tax status will terminate.

##### D. Deleted by SAB 103

##### E. Chronological Ordering of Data

**Question:** Does the staff have any preference in what order data are presented (e.g., the most current data displayed first, etc.)?

**Interpretive Response:** The staff has no preference as to order; however, financial statements and other data presented in tabular form should read consistently from left to right in the same chronological order throughout the filing. Similarly, numerical data included in narrative sections should be consistently ordered.

##### F. LIFO Liquidations

**Facts:** Registrant on LIFO basis of accounting liquidates a substantial portion of its LIFO inventory and as a result includes a material amount of income in its income statement which would not have been recorded had the inventory liquidation not taken place.

**Question:** Is disclosure required of the amount of income realized as a result of the inventory liquidation?

**Interpretive Response:** Yes. Such disclosure would be required in order to make the financial statements not misleading. Disclosure may be made either in a footnote or parenthetically on the face of the income statement.

##### G. Tax Equivalent Adjustment in Financial Statements of Bank Holding Companies

**Facts:** Bank subsidiaries of bank holding companies frequently hold substantial amounts of state and municipal bonds, interest income from which is exempt from Federal income taxes. Because of the tax exemption the stated yield on these securities is lower than the yield on securities with similar risk and maturity characteristics whose interest is subject to Federal tax. In order to make the interest income and resultant yields on tax exempt obligations comparable to those on taxable investments and loans, a "tax

equivalent adjustment" is often added to interest income when presented in analytical tables or charts. When the data presented also includes income taxes, a corresponding amount is added to income tax expense so that there is no effect on net income. Adjustment may also be made for the tax equivalent effect of exemption from state and local taxes.

**Question 1:** Is the concept of the tax equivalent adjustment appropriate for inclusion in financial statements and related notes?

**Interpretive Response:** No. The tax equivalent adjustment represents a credit to interest income which is not actually earned and realized and a corresponding charge to taxes (or other expense) which will never be paid. Consequently, it should not be reflected on the income statement or in notes to financial statements included in reports to shareholders or in a report or registration statement filed with the Commission.

**Question 2:** May amounts representing tax equivalent adjustments be included in the body of a statement of income provided they are designated as not being included in the totals and balances on the statement?

**Interpretive Response:** No. The tabular format of a statement develops information in an orderly manner which becomes confusing when additional numbers not an integral part of the statement are inserted into it.

**Question 3:** May revenues on a tax equivalent adjusted basis be included in selected financial data?

**Interpretive Response:** Revenues may be included in selected financial data on a tax equivalent basis if the respective captions state which amounts are tax equivalent adjusted and if the corresponding unadjusted amounts are also reported in the selected financial data.

Because of differences among registrants in making the tax equivalency computation, a brief note should describe the extent of recognition of exemption from Federal, state and local taxes and the combined marginal or incremental rate used. Where net operating losses exist, the note should indicate the nature of the tax equivalency adjustment made.

**Question 4:** May information adjusted to a tax equivalent basis be included in management's discussion and analysis of financial condition and results of operations?

**Interpretive Response:** One of the purposes of MD&A is to enable investors to appraise the extent that earnings have been affected by changes in business activity and accounting principles or

<sup>2</sup> Registrants also should apply the guidance of SOP 96-1 in determining the appropriate recognition of environmental remediation costs.