

the accounting policy should clearly state the accounting policy for each unit of accounting as well as how units of accounting are determined and valued. In addition, the staff believes that changes in estimated returns recognized in accordance with Statement 48 should be disclosed, if material (e.g., a change in estimate from two percent of sales to one percent of sales).

Regulation S-X requires that revenue from the sales of products, services, and other products each be separately disclosed on the face of the income statement.⁶⁴ The staff believes that costs relating to each type of revenue similarly should be reported separately on the face of the income statement.

MD&A requires a discussion of liquidity, capital resources, results of operations and other information necessary to an understanding of a registrant's financial condition, changes in financial condition and results of operations.⁶⁵ This includes unusual or infrequent transactions, known trends or uncertainties that have had, or might reasonably be expected to have, a favorable or unfavorable material effect on revenue, operating income or net income and the relationship between revenue and the costs of the revenue. Changes in revenue should not be evaluated solely in terms of volume and price changes, but should also include an analysis of the reasons and factors contributing to the increase or decrease. The Commission stated in FRR 36 that MD&A should "give investors an opportunity to look at the registrant through the eyes of management by providing a historical and prospective analysis of the registrant's financial condition and results of operations, with a particular emphasis on the registrant's prospects for the future."⁶⁶

Examples of such revenue transactions or events that the staff has asked to be disclosed and discussed in accordance with FRR 36 are:

- Shipments of product at the end of a reporting period that significantly reduce customer backlog and that reasonably might be expected to result in lower shipments and revenue in the next period.
- Granting of extended payment terms that will result in a longer collection period for accounts receivable (regardless of whether revenue has been recognized) and slower cash inflows from operations, and the effect on liquidity and capital resources. (The fair value of trade receivables should be disclosed in the footnotes to the financial

statements when the fair value does not approximate the carrying amount.)⁶⁷

- Changing trends in shipments into, and sales from, a sales channel or separate class of customer that could be expected to have a significant effect on future sales or sales returns.

- An increasing trend toward sales to a different class of customer, such as a reseller distribution channel that has a lower gross profit margin than existing sales that are principally made to end users. Also, increasing service revenue that has a higher profit margin than product sales.

- Seasonal trends or variations in sales.
- A gain or loss from the sale of an asset(s).⁶⁸

Question 2

Question: Will the staff expect retroactive changes by registrants to comply with the accounting described in this bulletin?

Interpretive Response: All registrants are expected to apply the accounting and disclosures described in this bulletin. The staff, however, will not object if registrants that have not applied this accounting do not restate prior financial statements provided they report a change in accounting principle in accordance with Opinion 20 and Statement 3 no later than the fourth fiscal quarter of the fiscal year beginning after December 15, 1999. In periods subsequent to transition, registrants should disclose the amount of revenue (if material to income before income taxes) recognized in those periods that was included in the cumulative effect adjustment. If a registrant files financial statements with the Commission before applying the guidance in this bulletin, disclosures similar to those described in SAB Topic 11.M should be provided.

However, if registrants have not previously complied with GAAP, for example, by recording revenue for products prior to delivery that did not comply with the applicable bill-and-hold guidance, those registrants should apply the guidance in Opinion 20 for the correction of an error.⁶⁹ In addition, registrants should be aware that

⁶⁷ Statement 107.

⁶⁸ Gains or losses from the sale of assets should be reported as "other general expenses" pursuant to Regulation S-X, Article 5-03(b)(6). Any material item should be stated separately.

⁶⁹ Opinion 20, paragraph 13 and paragraphs 36-37 describe and provide the accounting and disclosure requirements applicable to the correction of an error in previously issued financial statements. Because the term "error" as used in Opinion 20 includes "oversight or misuse of facts that existed at the time that the financial statements were prepared," that term includes both unintentional errors as well as intentional fraudulent financial reporting and misappropriation of assets as described in SAS 99.

the Commission may take enforcement action where a registrant in prior financial statements has violated the antifraud or disclosure provisions of the securities laws with respect to revenue recognition.

Question 3

Question: The previous question indicates that the staff will not object to cumulative effect-type transition so long as the prior accounting does not represent an error. Could a company whose prior accounting does not represent an error voluntarily adopt a new method consistent with this SAB Topic by restatement of prior periods, rather than through a cumulative catch-up adjustment?

Interpretive Response: In most instances, no. Opinion 20 does not permit restatement of financial statements for a change in accounting principle that does not represent correction of an error, except in very rare circumstances.⁷⁰ An exception is a company that is filing publicly for the first time. As stated in paragraph 29 of Opinion 20, those companies are permitted to reflect the adoption of the new policy via a restatement, and the staff believes that approach is usually necessary to avoid confusing investors in an initial public offering.

Question 4

Question: Should a registrant reporting a change in accounting principle as a result of this SAB Topic file a preferability letter?

Interpretive Response: No preferability letter is required if an accounting change is made in response to a newly issued Staff Accounting Bulletin.

Question 5

Question: If a company had not previously adjusted sales revenues, but deferred recognition of the gross margin of estimated returns for a transaction subject to Statement 48, how should it present a current change in accounting to reduce revenue and cost of sales for estimated returns?

Interpretive Response: Paragraph 7 of Statement 48 states that "sales revenue and cost of sales reported in the income statement shall be reduced to reflect estimated returns." Statement 48 does not provide for recognition of sales and costs of sales while deferring gross margin under any circumstance. This SAB Topic provides no new guidance on this point. If a registrant has failed to comply with GAAP, the registrant should retroactively revise prior financial statements in the manner set forth in Opinion 20 and Statement 16.

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⁷⁰ See, for example, Opinion 20, paragraph 27.

⁶⁴ See Regulation S-X, Article 5-03(b)(1) and (2).

⁶⁵ See Regulation S-K, Article 303 and FRR 36.

⁶⁶ FRR 36, also see In the Matter of Caterpillar Inc., AAER 363 (March 31, 1992).