period to recognize the investor's share of earnings or losses of the investee. The amount of the adjustment is included in the net income of the investor. Distributions received from an investee reduce the carrying amount of the investment.

- iii. It should be noted that the steps in the preceding paragraph determine only the cost basis of investments. Any investment included in an SBIC's portfolio of Loans and Investments still must be valued by the Board of Directors or General Partner(s) and presented at fair value in the Licensee's financial statements.
- iv. Any income from investment in flowthrough entities must be included initially in Non-cash Gains/Income, as discussed in paragraph X of this section V. When a Licensee actually receives a distribution from the investee, the amount received should be reclassified from Non-cash Gains/Income to Undistributed Net Realized Earnings.

J. Equity Method of Accounting

- i. The only type of investment which shall be accounted for under the equity method is an investment in the common stock of a Section 301(d) Licensee, as permitted under § 107.712. Since a Licensee investing in a Section 301(d) Licensee is required to have an ownership interest of at least 20 percent, use of the equity method will normally be appropriate. Under the equity method, original cost is adjusted at the end of each accounting period to recognize the investor's share of earnings or losses of the investee. The amount of the adjustment is included in the net income of the investor. Dividends or distributions received from an investee reduce the carrying amount of the investment.
- ii. Licensee should not use the equity method to account for investments in the common stock of small business concerns, even if a Licensee's ownership interest exceeds 20 percent. SBICs, whether or not registered under the Investment Company Act of 1940, are exempt from the usual requirements concerning use of the equity method because they account for investments at fair value (see APB Opinion No. 18, ''The Equity Method of Accounting for Investments in Common Stock'', paragraph 2).

K. Accounting for Income Taxes

- i. In February 1992, the FASB issued Statement No. 109, "Accounting for Income Taxes". The Statement is effective for fiscal years beginning after December 15, 1992. Statement No. 109 supersedes FASB Statement No. 96, as well as APB Opinion No. 11, which many companies continued to follow during the period when adoption of Statement No. 96 was optional.
- ii. Statement No. 109 establishes the following basic principles to be applied in accounting for income taxes at the date of financial statements:
- (1) A current tax liability or asset is recognized for the estimated taxes payable or refundable on tax returns for the current period.
- (2) A deferred tax liability is recognized for the estimated future tax effects of "taxable temporary differences" (events which will result in future taxes payable).

- (3) A deferred tax asset is recognized for the estimated future tax effects of "deductible temporary differences" (events which will result in future tax savings), operating loss carryforwards, and tax credit carryforwards.
- (4) A valuation allowance is recognized to reduce the deferred tax asset to the extent that the tax benefits are not expected to be realized.
- (5) Both current and deferred tax liabilities and assets are based on provisions of the enacted tax law; the effects of future changes in tax laws or rates are not anticipated.
- iii. The ability to recognize deferred tax assets under certain circumstances represents a significant change from earlier pronouncements. Licensees which recognize deferred tax assets should take careful note of the requirements of Statement No. 109 in determining whether it is "more likely than not" that such assets will be realized. Generally, application of the "more likely than not" standard means that when "negative evidence" exists which suggests that benefits will not be realized, there must be sufficient "positive evidence" to outweigh it; otherwise, a valuation allowance is required.
- iv. Because SBICs must report their Loans and Investments at value, many Licensees will find it necessary to apply the criteria of Statement No. 109 in determining whether to recognize deferred tax liabilities or assets reflecting the estimated future tax effects of unrealized gains or losses. Both unrealized gains and unrealized losses are temporary differences as defined in the statement. Previously, SBA required Licensees with net unrealized appreciation to record a provision for estimated future taxes, but did not permit Licensees with net unrealized depreciation to record a corresponding benefit. In accordance with current GAAP, such a benefit may now be recorded.
- v. The reporting of unrealized gains and losses and the related tax effects must be consistent. Since SBIC program accounting guidelines require that changes in unrealized appreciation or depreciation be excluded from net income (that is, they do not appear in the statement of operations realized), it follows that the related tax effects must be similarly excluded. Both elements, however, are included in "comprehensive income" (that is, they affect the equity of Licensees). This is reflected in the presentation of net unrealized appreciation or depreciation, net of estimated future tax effects, as Unrealized Gain (Loss) on Securities Held in the Capital section of the Statement of Financial Position.

L. Realized Gain (Loss) on Investments

- i. Realized gain or loss on investment shall be recorded by Licensees in accordance with generally accepted accounting principles.
- ii. Capital gains realized on the sale of securities shall be recognized provided that collection of proceeds is reasonably assured and the earnings process is complete. For the earnings process to be considered complete, the Licensee must have no further obligation related to the transaction. Any transaction with recourse upon the Licensee or involving any understanding, agreement, option, privilege, or other rights to repurchase by

and/or resell to the Licensee shall not be considered as a final transaction. Transactions which do not meet the criteria in this paragraph L for current recognition of gains shall be accounted for using an appropriate alternate method, such as the installment method or the cost recovery method. Under the installment method, a portion of the gain is recognized with each installment payment received; under the cost recovery method, no gain is recognized until the full amount of the seller's cost has been collected.

- iii. Capital losses may arise not only from sales, but also from write-offs or charge-offs of securities held (the two terms are generally used synonymously in this appendix; in contrast, the term "write-down" refers to the recording of unrealized depreciation). Writeoffs may be either full or partial. Writing off an investment, in comparison with recording unrealized depreciation, represents a stronger judgment concerning loss of value. However, it is not necessary to have a definitive event (such as bankruptcy of the small business concern) in order to write off an investment. Generally accepted accounting principles call for the recognition of loss when it becomes evident that previously recognized future economic benefits of an asset have been reduced or eliminated.
- iv. A Licensee may also realize capital gains or losses in connection with the exchange or non-reciprocal transfer of securities. The treatment of such transactions is governed by APB Opinion No. 29, "Accounting for Nonmonetary Transactions", and is discussed in paragraph M of this section V.
- v. If a Licensee acquires shares of an investee's stock (of the same class) at different times and prices, SBA requires that the average cost method be used to determine the cost of such securities when sold.
- vi. When a gain or loss is realized, whether as a result of the sale, other disposal or writeoff of an asset, any previously recorded unrealized appreciation or depreciation associated with the asset shall be reversed.
- vii. Non-cash Gains. When a Licensee realizes capital gains, but does not receive cash at the time of the transaction, SBA requires Licensees to segregate such "Noncash Gains" from other components of Undistributed Realized Earnings, until such time as any non-cash assets received are converted to cash. Non-cash Gains are realized earnings which have been recognized in the Licensee's Statement of Operations. They are segregated in the Statement of Financial Position only because they are subject to certain restrictions under SBA regulations, primarily concerning distributions. In effect, Non-cash Gains can be considered a type of restricted retained earnings. For further information on Noncash Gains, see "Undistributed Realized Earnings" in paragraph X of this section V.

M. Nonmonetary Transactions

i. Licensees should follow APB Opinion No. 29 to the extent applicable when accounting for nonmonetary transactions. Such transactions include both reciprocal and non-reciprocal transfers of nonmonetary assets or liabilities between the Licensee and