



DIVISION OF
MARKET REGULATION

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

October 25, 1999

Mr. William T. Yates
Vice President & Controller
Advanced Clearing, Inc.
4211 South 102nd Street
P.O. Box 2226
Omaha, NE 68103-2226

Re: Net Capital Treatment of Deferred Tax Liabilities Directly Related to
Prepaid Advertising Expense

Dear Mr. Yates:

This responds to your letter dated March 23, 1999, on behalf of Advanced Clearing, Inc. (the "Firm"), regarding the net capital treatment under Rule 15c3-1 under the Securities Exchange Act of 1934 ("Exchange Act")¹ of its deferred tax liability directly related to prepaid advertising expense.

Based on your letter and conversations with the staff of the Division of Market Regulation ("Division"), I understand the following facts to be pertinent to your request. Paragraph (c)(2)(iv) of Rule 15c3-1 requires a broker-dealer when computing net capital to deduct from its net worth certain illiquid or nonallowable assets. In addition, paragraph (c)(2)(i)(C) of Rule 15c3-1 provides that a broker-dealer may add back to its net worth when computing net capital certain deferred tax liabilities which directly relate to: (1) income derived from nonallowable assets; (2) unrealized gains on assets subject to haircuts under paragraph (c)(2)(vi) and Appendices A and B of Rule 15c3-1 at the applicable tax rates; or (3) unrealized gains on assets otherwise deducted from net worth.

You request that the Firm be allowed to add back to its net worth the amount of its deferred tax liability which relates to prepaid advertising expense.² You state that Generally Accepted Accounting Principles ("GAAP") requires the Firm to recognize its prepaid advertising expense in the period in which the advertising takes place and

¹ 17 C.F.R. § 240.15c3-1 (1999).

² The Firm prepays its advertising expense with a current cash payment.

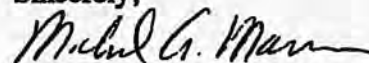
Mr. William T. Yates
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that the Internal Revenue Code permits the deduction of prepaid advertising expense in the period in which it is paid. You further state that the Firm accounts for this tax-to-book discrepancy by recognizing a deferred tax liability and a related nonallowable asset entitled "prepaid advertising."

You contend that the net capital treatment of the deferred tax liability should be similar to the treatment under paragraph (c)(2)(i)(C) of Rule 15c3-1 because it is directly related to a nonallowable asset. You further contend that the deferred tax liability does not affect the Firm's cash flows, income tax liability or overall operating risk profile and that the journal entry "merely alters the timing under which advertising costs are recognized in book net income." However, you assert that the accounting treatment for prepaid advertising expense results in an inappropriate double charge to net capital because the asset entitled prepaid advertising is nonallowable and the deferred tax liability also reduces the Firm's net worth.³

Based on the foregoing, the Division will not recommend enforcement action if, when computing net capital, the Firm adds back the amount of its deferred tax liability which directly relates to the nonallowable asset entitled prepaid advertising. You should be aware that this is a staff position with respect to enforcement only and does not purport to express any legal conclusions. This position is based solely on the foregoing description. Factual variations could warrant a different response, and any material change in the facts must be brought to the Division's attention. This position may be withdrawn or modified if the staff determines that such action is necessary for the protection of investors, in the public interest, or otherwise in furtherance of the purposes of the securities laws.

Sincerely,



Michael A. Macchiaroli
Associate Director

cc: Raymond J. Hennessy, NYSE
Thomas R. Cassella, NASD

³ Exchange Act Release No. 18737 (May 13, 1982), 47 FR 23919 (June 2, 1982) specifically requires a broker-dealer to adopt the accrual method of accounting under GAAP for its financial reporting.



ADVANCED
CLEARING, INC.

March 23, 1999

Michael A. Macchiaroli, Esquire
Associate Director
Office of Risk Management and Control
Securities and Exchange Commission
450 5th Street, N.W. Stop 5-1
Washington, DC 20549

Re: Net Capital Implications of Prepaid Advertising Costs

Dear Mr. Macchiaroli:

This letter request that the staff of the Division of Market Regulation ("Division") grant Advanced Clearing, Inc. a "no-action" position allowing it to net certain deferred advertising costs with related deferred tax liabilities for purposes of computing net capital under Securities Exchange Act Rule 15c3-1.

Specifically, Advanced Clearing pays for certain advertising costs in advance of the time that the advertising is displayed. Generally accepted accounting principles ("GAAP") require those costs be initially recorded as assets, and then amortized at the time that the advertising is shown. Although advertising costs are deductible in the year incurred, GAAP also requires that Advanced Clearing defer recognition of the tax benefit of the deduction until the time the advertising is displayed. To accomplish that deferral, Advanced Clearing records a deferred tax liability.

Paragraph (c)(2)(iv) of Rule 15c3-1 requires that the broker-dealer deduct from net worth in arriving at net capital "assets that are not readily convertible into cash". For Advanced Clearing, this means that its deferred advertising cost is given no value in computing net capital. Paragraphs (c)(2)(i)(C)(2) and (3) provide the instances under which deferred tax liabilities may be added back to net worth in computing net capital. Paragraph (c)(2)(i)(C)(2) allows the broker-dealer to add back those deferred tax liabilities that relate to "income accrued". Paragraph (c)(2)(i)(C)(3) allows the broker-dealer to add back those deferred tax liabilities that relate to "unrealized appreciation in value of any asset(s) which has been otherwise deducted from net worth in accordance with this section." We understand that the staff has taken the position that deferred tax liabilities related to prepaid advertising costs do not fall within paragraphs (c)(2)(i)(C)(2) and (3).

Michael A. Macchiaroli, Esquire
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While deferring recognition of the advertising expense has the effect of increasing income and net worth, absent a change in regulatory application, the accounting treatment for deferred taxes causes Advanced Clearing's net capital to decline. This is due to the fact that the resultant increase in earnings is reduced by the effect of income taxes, while the net capital deduction is not reflected on a tax-adjusted basis in the net capital computation. For example, for each \$1,000 of advertising expense capitalized, equity capital would be increased by \$600 (the \$1,000 deferred expense reduced by the \$600 in income tax expense generated by the additional reported income). The same \$1,000 will be included at 100% as a nonallowable asset in calculating net capital, creating a \$400 net reduction in net capital for regulatory purposes.

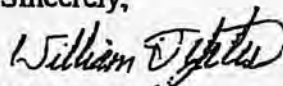
should be \$400
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This negative impact on net capital will be eliminated as the advertising is displayed without any out lay of funds. During that time, the prepaid advertising asset and related deferred tax liability are amortized by journal entry through earnings. This negative impact occurs even though there has been no change in the firm's cash flows, income tax liability or overall operating risk profile. The GAAP treatment of the advertising merely alters the timing under which advertising costs are recognized in book net income, and in doing so creates an unintended negative net capital consequence through our balance sheet.

We believe that while the deferred tax liabilities related to advertising costs may not meet a precise reading of the language of paragraphs (c)(2)(i)(C)(2) and (3), we believe that the policy implications are the same or better. Those paragraphs recognize that since the rule assumes that the related assets have no saleable value and would be written off, no tax liability would be owed. In the instances recognized by the rule, the ultimate realization (sale of an appreciated asset or collection of a receivable) may in fact cause the deferred tax liability to become an actual tax liability. In our case, the deferred tax liability will merely be eliminated by journal entry when the advertising is displayed and not become an actual tax liability. In that way, we believe that our request is in line with the policy interests of the Division.

We appreciate your prompt consideration of our proposal. Should you have any questions or comments, please do not hesitate to contact me at 402-597-7722.

Sincerely,



William T. Yates
Vice President & Controller