



SEC Staff Review of Common Financial Reporting Issues Facing Smaller Issuers

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These slides were presented at the Forums on Auditing in the Small Business Environment hosted by the PCAOB during 2009. Participants were auditors from smaller registered public accounting firms. The slides are intended to provide a sampling of issues that the CF Staff frequently encounters when reviewing filings for smaller public companies as well as an overview of developments within the Division of Corporation Finance. Comments issued by the CF Staff may be different or additional to those included here based upon individual facts and circumstances. The slides are accompanied by detailed footnotes that provide additional context.

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Agenda

- ❖ **Overview**
- ❖ **The Comment Letter Process**
- ❖ **Recent Developments**
- ❖ **Financial Reporting Issues Frequently Raised in Comment Letters**
- ❖ **Resources**



Overview

Division of Corporation Finance (DCF)

Mission – “To see that investors are provided with material information in order to make informed investment decisions — both when a company initially offers its stock to the public and on a regular basis as it continues to give information to the marketplace.”

- ❖ **Selectively review the disclosure documents filed by public companies (including initial registrations)**
- ❖ **Provide interpretive assistance to companies on SEC rules and forms**
- ❖ **Propose new and revised rules to the Commission**

Organization

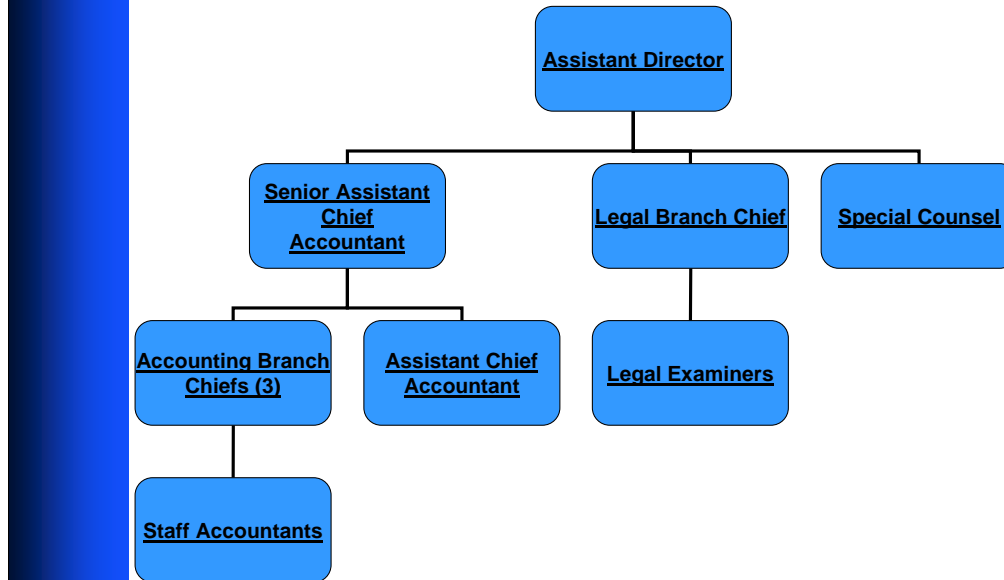
- ❖ **11 industry groups**
- ❖ **Legal and Regulatory Policy Offices**

The Division of Corporation Finance assists the Commission in executing its responsibility to oversee corporate disclosure of important information to the investing public. Corporations are required to comply with regulations pertaining to disclosure that must be made when stock is initially sold and then on a continuing and periodic basis. The Division of Corporation Finance Staff (“CF Staff”) routinely reviews the disclosure documents filed by companies. The Staff also provides companies with assistance interpreting the Commission's rules and recommends to the Commission new rules for adoption.

The Division of Corporation Finance reviews documents that publicly-held companies are required to file with the Commission. These documents disclose information about the companies' financial condition and business practices to help investors make informed investment decisions. Through the Division's review process, the CF Staff checks to see if publicly-held companies are meeting their disclosure requirements and seeks to improve the quality of the disclosure.

Corporation Finance provides administrative interpretations of the Securities Act of 1933, the Securities Exchange Act of 1934, and the Trust Indenture Act of 1939, and recommends regulations to implement these statutes. The CF Staff provides guidance and counseling to registrants, prospective registrants, and the public to help them comply with the law and related regulations. For example, a company might ask whether the offering of a particular security requires registration with the SEC. Corporation Finance would share its interpretation of the relevant securities regulations with the company and give its informal advice on compliance with the appropriate disclosure requirement. The Division uses no-action letters and interpretive letters to provide guidance on the regulations in a more formal manner.

Division of Corporation Finance (DCF) Industry Groups



From <http://www.sec.gov/divisions/corpfin/cffilingreview.htm>:

The Division performs its primary review responsibilities through eleven offices Staffed with approximately 80 percent of the Division's employees. The members of these eleven offices have specialized industry, accounting, and disclosure expertise. The Division assigns filings by companies in a particular industry to one of the eleven Assistant Director Offices. The Division has Staffed each office with 25 to 35 professionals, primarily accountants and lawyers. An Associate Director (Paul Belvin, James Daly, or Barry Summer) oversees each Assistant Director Office. The Deputy Director (Shelley Parratt) and Director (Meredith Cross) oversee the entire filing review process.

Corporation Finance Office of the Chief Accountant

Provides technical support to industry groups

Pre-filing submissions (dcaoletters@sec.gov)

- ❖ Interpretations of reporting requirements
- ❖ Accommodations of reporting requirements
- ❖ Interpretations on the application of GAAP (should be sent to - OCA@sec.gov)

Rulemaking impacting financial reporting

The Division's Office of Chief Accountant (CF-OCA) answers questions regarding financial reporting and related issues, including the requirements relating to the form and content of financial statements required to be included in Commission filings. Questions may be submitted to CF-OCA by telephone and by [online form](#). Letters requesting a waiver or accommodation relating to certain financial reporting requirements may be submitted to CF-OCA via dcaoletters@sec.gov. Companies and their advisors seeking interpretive guidance or informal advice on applying the Commission's financial reporting requirements, such as Regulation S-X, should contact CF-OCA.

CF-OCA works closely with the Division's Disclosure Operations Groups in resolving accounting and financial reporting issues that arise through the comment letter process. The office also works closely with the Commission's Office of the Chief Accountant in addressing pre-filing submissions on the application of GAAP pertaining to specific registrants.

SEC Office of the Chief Accountant

- ❖ Carries out the day-to-day work to assist the Commission in its oversight role over the FASB and PCAOB
- ❖ Consults with registrants and auditors regarding the application of accounting, auditing, and independence standards
 - www.sec.gov/info/accountants/ocasubguidance.htm
- ❖ OCA and DCF work together closely on:
 - Consultations on certain technical matters relating to the application of GAAP and auditing matters
 - Rulemaking impacting financial reporting and auditing
 - Consultations from registrants
 - Pre-clearance
 - Staff comments

The Chief Accountant is principal adviser to the Commission on accounting and auditing matters. The Office of the Chief Accountant assists the Commission in executing its responsibility under the securities laws to establish accounting principles, and for overseeing the private sector standards-setting process. The Office works closely with the Financial Accounting Standards Board, to which the SEC has delegated authority for accounting standards setting.

In addition to its responsibility for accounting standards, the Commission is responsible for the approval or disapproval of rules put forward by the Public Company Accounting Oversight Board, a private-sector regulator established by the Sarbanes-Oxley Act to oversee the auditing profession. The Commission also has oversight responsibility for all of the activities of the PCAOB, including approval of its annual budget. To assist the Commission in the execution of these responsibilities, the Office of the Chief Accountant is the principal liaison with the PCAOB. The Office also consults with registrants and auditors on a regular basis regarding the application of accounting and auditing standards.

Because of its expertise and ongoing involvement with questions concerning the financial books and records of public companies registered with the SEC, including their independent auditors, the Office of the Chief Accountant is often called upon to assist in addressing issues that arise in the context of Commission enforcement actions.

DCF — Office of Small Business Policy

- ❖ **Answers questions on disclosure and other issues relating to smaller public companies, including those classified as "smaller reporting companies," and on limited, private, and intrastate offerings of securities.**
- ❖ **Acts as the Division's liaison to the state securities regulators on corporate finance issues and the Small Business Administration and serves as small business intermediary for the Commission.**
- ❖ **Develops rulemaking initiatives and assists in other rulemaking that may affect smaller and private companies.**

The Office of Small Business Policy (OSBP) answers questions on disclosure and other issues relating to smaller public companies, including those classified as "smaller reporting companies," and on limited, private, and intrastate offerings of securities. Examples of specific topics about which OSBP answers questions include:

- Regulation D — Rules 504, 505, and 506 — and Form D
- Section 3(a)(11) and Rule 147 — intrastate securities offerings
- Rule 701 — equity incentive compensation for employees of non-Exchange Act reporting companies, both domestic and foreign
- Regulation A

Questions may be submitted to OSBP by telephone or by [on-line form](#). Letters requesting a no-action position or interpretive advice also may be submitted to OSBP. In addition, OSBP acts as the Division's liaison to the state securities regulators on corporate finance issues and the Small Business Administration. OSBP assists in and reviews rulemaking initiatives, as well as other Commission actions, which may have small business implications.

OSBP also reaches out to smaller companies to facilitate capital formation. These efforts include coordinating the annual SEC Government-Business Forum on Small Business Capital Formation, which focuses on the current status of issues and programs related to small business capital formation.



The Comment Letter Process

Comment Letter Process

Filings Subject to Staff Review

- ❖ **Selected by the DCF non-public screening criteria and Sarbanes-Oxley Section 408 requirements**
- ❖ **IPOs**
- ❖ **Other registration statements**
- ❖ **Annual reports**
- ❖ **Proxy statements**
- ❖ **Item 4.01 and Item 4.02 Forms 8-K**

As required by the Sarbanes-Oxley Act of 2002, the Division undertakes some level of review of each reporting company at least once every three years and reviews a significant number of companies more frequently. In addition, the Division selectively reviews transactional filings – documents companies file when they engage in public offerings, business combination transactions, and proxy solicitations.

In deciding how to allocate staff resources among filings, the Division undertakes a substantive evaluation of each company's disclosure in what it calls a preliminary review. To preserve the integrity of the selective review process, the Division does not publicly disclose its preliminary review criteria. Based on its preliminary review, the Division decides whether to undertake any further review of the company's filings or whether the company's disclosure appears to be substantially in compliance with the applicable accounting principles and the federal securities laws and regulations.

In addition, the CF Staff also reviews each Form 8-K filed on Items 4.01 and 4.02 for compliance with the disclosure requirements and issues comment letters as necessary.

Comment Letter Process

Types of Comments

- ❖ **Request for additional supplemental information**
- ❖ **Provide additional or different disclosure in a future filing**
- ❖ **Amend filing to revise financial statements or disclosure**
- ❖ **No further comments letter**

Levels of Review

If the Division selects a filing for further review, the level of further review may be:

- a full cover-to-cover review in which the CF Staff will examine the entire filing for compliance with the applicable requirements of the federal securities laws and regulations;
- a financial statement review in which the CF Staff will examine the financial statements and related disclosure for compliance with the applicable accounting standards and the disclosure requirements of the federal securities laws and regulations; or
- a targeted issue review in which the CF Staff will examine the filing for one or more specific items of disclosure for compliance with the applicable accounting standards and/or the disclosure requirements of the federal securities laws and regulations.

Staff Comments

The Division views the comment process as a dialogue with a company about its disclosure. The Division's comments are in response to a company's disclosure and other public information and are based on the CF Staff's understanding of that company's facts and circumstances. In issuing comments to a company, the CF Staff may request that a company provide additional supplemental information so we can better understand the company's disclosure, revise disclosure in a document on file with the SEC, provide additional disclosure in a document on file with the SEC, or provide additional or different disclosure in a future filing with the SEC.

Comment Letter Process

Best Practices for Resolving Issues

- ❖ **Prepare a thorough response**
 - **An invitation to dialogue**
 - **Key response to initial comment**
 - **Indicate specifically where revisions have been made**
 - **Discuss supporting authoritative literature in detail**
- ❖ **Inform Staff if you are unable to respond by the requested date**
- ❖ **Document accounting decisions contemporaneously**
- ❖ **Furnish all correspondence with the Staff on EDGAR**

A company generally responds to each comment in a letter to the CF Staff. A company's explanation or analysis of an issue will often satisfactorily resolve a comment. Depending on the nature of the issue, the CF Staff's concern, and the company's response, the CF Staff may issue additional comments following its review of the company's response to its prior comments. This comment and response process continues until the CF Staff and the company resolve the comments. In some cases, the CF Staff an amendment to a previously filed report may be necessary as the result of comments.

It is helpful when registrants take the time to prepare a thorough response. A good response focuses on the specific questions asked by the CF Staff, yet is sufficiently robust to allow the CF Staff to fully understand the accounting and/or disclosure at question. If the registrant has revised its filing or plans on revising its filing in response to the CF Staff's comments, it is also very helpful to provide proposed disclosure or marked pages. If the CF Staff has asked a question on the registrant's basis for a particular accounting treatment, it is helpful for the registrant to refer to any literature in GAAP that it relied upon to reach its conclusions.

Again, providing a detailed and complete explanation to the CF Staff in response to the initial comment letter may lessen the likelihood of future comments or at least narrow the dialogue. If you unable to respond by the date requested in the letter, you can contact the CF Staff and discuss the date on which you expect to respond.

Finally, it may be easier to respond to comments if you have documented your significant accounting decisions contemporaneously with the literature you relied upon, the alternatives considered, and the basis for your conclusions.



Recent Developments

Key SEC Developments

Rulemaking

- ❖ ***Interactive Data to Improve Financial Reporting (“XBRL”)***
 - **Effective for fiscal periods ending on or after June 15, 2011 (quarterly reports) for all but large accelerated filers.**
- ❖ ***Modernization of Oil and Gas Reporting***
 - **Effective for filings after January 1, 2010**
- ❖ ***Proposed Roadmap for the Potential Use of Financial Statements Prepared in Accordance With IFRS by U.S. Issuers***
- ❖ ***Technical amendments to SEC Rules for SFAS 141R and SFAS 160***
- ❖ ***Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers***
 - **Defers attestation requirement to fiscal years ending on or after June 15, 2010**

XBRL – Registrants must include financial statements and any applicable financial statement schedules in XBRL format as an exhibit to both filings made on EDGAR and on the company’s website. This requirement to Securities Act registration statements (other than IPOs), quarterly and annual reports, and transition reports, as well as reports on Forms 8-K or 6-K that contain specified financial statements. The XBRL rules apply to domestic and foreign companies (US GAAP & IFRS) and were effective for the largest of accelerated filers this year (for calendar year-end companies). Smaller reporting companies are required to comply with the rules by latter half of 2011 at the latest.

The Oil and Gas release is designed to modernize and update the oil and gas disclosure requirements to align them with current practices and changes in technology.

Proposed Roadmap – lists seven milestones which, if achieved, could lead to the use of IFRS by U.S. issuers in their filings with the Commission. The comment period closed on April 20, 2009 and comments are currently under consideration.

Technical Amendment – In April 2009, the Commission approved various technical amendments throughout the SEC rules to conform to changes in US GAAP as the result of the effectiveness of SFAS 141(R) and SFAS 160.

On October 2, 2009, the Commission announced that nonaccelerated filers will need to begin complying with auditor attestation requirements of Sarbanes-Oxley Act Section 404(b) for all fiscal years ending on or after June 15, 2010. In this regard, on October 13, the Commission issued Release No. 33-9072 extending the fiscal period end compliance date from December 15, 2009 to June 15, 2010. This change effectively defers the requirement another year for calendar year-end companies that are nonaccelerated filers.

Key SEC Developments

Staff Initiatives

- ❖ **Division of Corporation Finance Financial Reporting Manual**
 - www.sec.gov/divisions/corpfin/cffinancialreportingmanual.shtml
- ❖ **Corporation Finance Compliance and Disclosure Interpretations**
 - www.sec.gov/divisions/corpfin/cfguidance.shtml
- ❖ **Sample Letters Sent to Public Companies on MD&A Disclosure Regarding the Application of SFAS 157 (Fair Value Measurements)**
 - **September 2008 --**
www.sec.gov/divisions/corpfin/guidance/fairvalueltr0908.htm
 - **March 2008 --**
www.sec.gov/divisions/corpfin/guidance/fairvalueltr0308.htm
- ❖ **Sample Letter Sent to Public Companies on MD&A Disclosure Regarding Provisions and Allowances for Loan Losses**
 - **August 2009 -**
www.sec.gov/divisions/corpfin/guidance/loanlossesltr0809.htm

In December 2008, the Staff in the Division of Corporation Finance published its Financial Reporting Manual. The Manual is designed to be an internal reference document for the CF Staff; however, it has been published on the website in the interest of transparency. Due to its informal nature, it does not necessarily contain a discussion of all material considerations necessary to reach a conclusion. However, we believe that the Manual can be a helpful resource for registrants to consider in their financial reporting. We plan to update the Manual on a periodic basis (generally quarterly) for any changes.

The CF Staff has also begun publishing Compliance and Disclosure Interpretations (“C&DIs”) on the Division of Corporation Finance page of the SEC website. These interpretations have replaced the previously published Telephone Interpretations Manual. They are categorized by rule, regulation or form and are updated on a regular basis. They cover a broad range of topics that may include financial reporting in some circumstances. The CF Staff notifies the public of updates to the Manual and C&DIs via a “What’s New?” link on the website.

In March 2008 and September 2008, the Division Staff sent letters to certain registrants with suggested disclosures related to fair value measurements for consideration in preparing Management’s Discussion and Analysis. For the benefit of all preparers, the letters have been made publicly available on the Corporation Finance page of the SEC website. The March letter is focused on disclosure related to the use of unobservable inputs in fair value measurements. The September letter addresses the judgments and assumptions underlying fair value measurements, the sensitivity of the measurements to those assumptions, and details about the methodology and inputs.

In August 2009, the Division Staff issued a letter to certain companies pertaining to disclosures regarding provisions and allowances for loan losses which also included on the website. This letter pertains to the reconsiderations of various judgments in light of the current economic crisis. It primarily covers higher risk loans, changes in practices, and declines in collateral value.

Key SEC Developments

- ❖ ***Corporation Finance Request Form for Interpretive Advice and Other Assistance***
 - https://tts.sec.gov/cgi-bin/corp_fin_interpretive
- ❖ ***Staff Accounting Bulletins No. 111, 112, & 113***
- ❖ ***SEC Staff Announcement, EITF Topic D-110: Escrowed Share Arrangements and the Presumption of Compensation***

The SEC Staff is a valuable resource for various regulatory and reporting questions. Each of the Legal and Regulatory Policy offices within the Division responds to telephone inquiries from the public seeking interpretive guidance. In order to facilitate this process, the CF Staff created a web-based request form for the general use of the public. The form (hyperlinked above) allows an individual to submit a detailed questions with any supporting literature and direct it to a particular office within the Division. The use of the form as opposed to the telephone should expedite a complete response depending on the level of information provided.

In April 2009, June 2009, and October 2009, the Staff issued SABs 111, 112, and 113, respectively. The intent of each of these SABs was to align previously published staff guidance with changes in GAAP and SEC rules, specifically FASB Staff Position No. FAS 115-2 and FAS 124-2, SFAS 141(R) and SFAS 160, and the SEC's FR-78 related to oil and gas reporting.

Recently, the Staff has seen a growing number of principal stockholder and executive officers of smaller companies enter into escrowed share arrangements on behalf of the registrant in financing transactions. In the SEC Staff Announcement from June 2009 (EITF Topic D-110), the Staff clarified SEC Staff views on overcoming the presumption that for certain shareholders these arrangements represent compensation.

Other Recent Developments

FASB Accounting Standards Codification -- asc.fasb.org

- ❖ **Launched on July 1, 2009 and effective for fiscal periods ending after 9/15/09**
- ❖ **SEC Interpretive Release No. 33-9062A -- *Commission Guidance Regarding the Financial Accounting Standards Board's Accounting Standards Codification***
- ❖ **Reconsider accounting policy disclosures and GAAP references**
 - ❖ **Policy disclosures should now reference Codification if referring to anything**
- ❖ **References to SEC Guidance should not change**
- ❖ **New GAAP (i.e., amendments to Codification) will be via Codification Updates (SAB 74)**

On June 30, 2009, the FASB issued FASB Statement of Financial Accounting Standards No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles – a replacement of FASB Statement No. 162 (Statement No. 168), to establish the FASB Codification as the source of authoritative non-Commission accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in conformity with U.S. generally accepted accounting principles (“U.S. GAAP”). Statement No. 168 was effective for financial statements issued for interim and annual periods ending after September 15, 2009. The FASB Codification reorganizes existing U.S. accounting and reporting standards issued by the FASB and other related private-sector standard setters, and all guidance contained in the FASB Codification carries an equal level of authority.

In conjunction with the Codification, the Commission issued an interpretive release (No. 33-9062A). Since the Codification superseded all references to U.S. GAAP and SEC rules, regulations, and forms have not yet been revised accordingly, the interpretive release advises preparers to look to the appropriate codification reference as outlined in the cross-reference table when using GAAP references in SEC rules, regulations, or forms.

In response to the Codification, Companies might also reconsider their accounting policy disclosures. While legacy GAAP references are inappropriate within footnote disclosures with the release of the codification, companies are encouraged to revisit their policy disclosures and ensure they are in plain English. In many cases, references to accounting literature may not be necessary if your actual policy is clearly disclosed. A similar rethinking may also apply to disclosures presented under SAB 74 pertaining to the adoption of new accounting pronouncements.

Certain SEC rules, regulations, SABs, and Staff Announcements from EITF meetings have been included in the Codification for ease of reference and as a convenience. Only those requirements and Staff positions that apply to preparing a set of GAAP financial statements have been included. Many other SEC rules, regulations, SABs, and Staff Announcements have not been included, therefore, when referring to SEC materials, registrants should continue to refer to the source material.



***Financial Reporting Issues
Frequently Raised in Comment
Letters***

Financial Reporting Issues Frequently Raised in Comment Letters

- ***Impact of the Financial Crisis on Financial Statements***
- ***Management's Discussion & Analysis***
- ***Reverse Mergers & "Back Door" Registrations***
- ***Business Combinations***
- ***Equity Transactions***
- ***Embedded Conversion Options and Freestanding Warrants***
- ***Smaller Reporting Company Status***
- ***Disclosure Controls and Procedures***
- ***Internal Control over Financial Reporting***
- ***Other (see Appendix)***

Impact of the Financial Crisis on the Financial Statements

❖ Goodwill and Indefinite-Lived Intangible Assets

- Identification of reporting units
- Annual testing date vs. interim impairment tests
- 2-step testing method and how FV is estimated
- Changes in methodologies or assumptions from last test

❖ PP&E and Intangible Assets

- Triggering Events
- Methodology and key assumptions

❖ Investments

- SFAS 157 (ASC 820-10) disclosures re: how you determine fair value
- OTTI considerations

GAAP requires that companies consider whether an event has occurred that “would more likely than not reduce the fair value of a reporting unit below its carrying value.” In reviewing disclosures, CF Staff may consider certain publicly available information in and out of the company’s filings in assessing whether it seems likely that such an event has occurred. It may be helpful for companies to consider the following events or indicators in considering whether an interim impairment test is appropriate: (1) *Other impairment charges* (2) *Cash or operating losses at reporting unit level* (3) *Industry factors* (4) *Revisions to forecasts* (5) *Restructuring plans*

Generally, the assumptions used to value goodwill should be consistent with assumptions used in valuing other assets allocated to the reporting unit such as long-lived assets, intangible assets, and deferred tax assets. For example, if the reporting unit for a retail chain is a particular store or geographic area, we would expect the estimated future cash flows and discount rates related to acquired franchise rights, customer relationships, and in some cases, PP&E to be impacted in a similar fashion as goodwill by current events.

CF Staff continues to focus on the measurement of certain investments that may be held by any company regardless of size or industry in light of the current economic environment. The FASB has provided additional guidance on how companies should consider whether an investment trades in an active market for determining fair value as well as guidance on the measurement and recognition of other than temporary impairment. Equity securities continue to be evaluated based upon the ability and intent to hold to recovery. These judgments are expected to be consistent with other disclosures throughout the filing including going concern, liquidity in MD&A, etc. For debt securities, GAAP requires that companies consider whether it intends to sell the debt security or it is more likely than not that it will be required to sell the debt security prior to its recovery of amortized cost. These conclusions should also be consistent with other disclosures throughout the filing.

Impact of the Financial Crisis on the Financial Statements

❖ Accounts receivable

- Consider current events in estimating allowances for uncollectible accounts (“historical experience” may not be sufficient)

❖ Inventory

- Lower of cost or market valuations - Impact of price reductions or reduced sales
- Obsolescence considerations

❖ Deferred tax asset (valuation allowances)

❖ Disclosure of Risks and Uncertainties (SOP 94-6) (ASC Topic 275)

Most companies have established policies for reserving and writing off accounts receivable based upon aging or a standard percentage. In this current time, delinquencies are on the increase. While the market may recover allowing companies to get back to their historical collection rates, companies should not ignore the current environment’s impact on delinquencies on the receivables they currently have recorded in their financial statements.

Consumer spending has been greatly affected as a result of the economic crisis. Inventory has been turning over more slowly. As a result, companies need to carefully consider their inventory valuations. As inventory turnover begins to decline each period, the CF Staff may raise questions about price and lower of cost or market evaluations. Comments may seek to understand the price at which the company is currently selling its product in comparison to cost and if the product is not selling whether the company has considered obsolescence.

Companies should consider the impact of the current economic environment on the realizability of their deferred tax assets. It is helpful disclosure to clearly explain the approach for determining whether a valuation allowance is appropriate. It also may be helpful for readers to understand what new evidence the company has obtained related to the realization of deferred tax assets and how it has evaluated that evidence in reaching its conclusions. Due to changes in the economic environment and increased negative evidence, companies may adjust their tax planning strategies to increase the likelihood of utilizing deferred tax assets. If deferred tax assets are only realizable as the result of changes in tax planning strategies to overcome new negative evidence, it is helpful for preparers to discuss those changes in addition to the impact that those changes may have on the business other than as they relate to income taxes.

In all of the areas discussed above, the CF Staff encourages companies to consider the need for “early warning” disclosures in the notes to the financial statements under FASB ASC Topic 275. To the extent an impairment charge or valuation allowance was not recorded or to the extent that a partial valuation allowance was recorded, it is helpful to put investors “on notice” if it is reasonably possible that a charge or additional charge could be recorded in a future period.

Management's Discussion & Analysis (MD&A)

Release Nos. 33-6835 and 33-8350 Best Practices

- ❖ **Executive-level overview (including discussion of impact of current economic conditions)**
- ❖ **Critical accounting estimates**
 - **Provide insight into the quality and variability of financial information (including fair value measurements)**
 - **Discuss significant estimates and assumptions used by management when evaluating assets for recoverability**
- ❖ **Comparative results of operations that are thorough and address the key drivers of change**
- ❖ **Early warning disclosures – Item 303(a)(3)(ii) of Regulation S-K**

MD&A has three general objectives: to provide a narrative explanation of a company's financial statements through the eyes of management; to enhance the overall financial disclosure and provide the context within which financial information should be analyzed; and to provide information about the quality of, and potential variability of, a company's earnings and cash flow, so that investors can ascertain the likelihood that past performance is indicative of the future.

In accomplishing these objectives, CF Staff generally recommends that companies provide an overview highlighting BOTH financial and non-financial key performance indicators as background to understanding the company's overall performance for the periods.

Depending on the nature of a company's operations, it may have certain estimates that have a material impact on the underlying financial statements and are subject to significant judgment and uncertainty. With the intent of providing insight in to the quality and variability of the financial statements, management is encouraged to clearly identify those estimates, provide readers with an understanding of the methodology and underlying assumptions to arrive at the estimate and analyze the impact that reasonable changes in the assumptions could have on the financial statements.

The CF Staff often finds that registrants do not adequately discuss the factors contributing to fluctuations in operating activities from period to period. The discussion of fluctuations should help readers understand the factors that contributed to changes in underlying line items and the magnitude of their impact.

Equally important as the disclosure of impairment losses may be the disclosure of "non-impairments" or "non-events" in certain situations. MD&A requires companies to disclose known uncertainties that the registrant reasonably expects will have a material impact on income from continuing operations. Using goodwill as an example, registrants may want to consider, for example, providing appropriate disclosures when they have triggered an impairment test and come close to failing Step 1. Similarly, in cases where they have actually failed Step 1, but concluded that an impairment charge is not necessary under Step 2, it could also be useful to put investors "on notice." Finally, registrants may want to consider warning investors in situations where they have not yet triggered an interim impairment test, but events that are reasonably likely to occur may require it in the near future. The Staff may issue comments to companies in situations where the events that trigger an impairment or other charge appear to have been predictable in an earlier period but the circumstances were never addressed in disclosure previously.

Management's Discussion & Analysis (MD&A)

Liquidity and capital resources

- ❖ **Enhanced analysis and explanation of the sources and uses of cash**
 - **Consider categories reported on statement of cash flows**
- ❖ **Address going concern matters**
- ❖ **Discuss liquidity known trends - Item 303(a)(1) of Regulation S-K**
- ❖ **Discuss the prospective sources of and need for capital**
- ❖ **Consider enhanced disclosure regarding debt instruments, guarantees and related covenants**
- ❖ **Address the nature and extent of all restrictions**
 - **Explain how the restrictions limit the ability to transfer funds to its parent and the impact the restrictions have had and are expected to have on the parent's ability to meet its cash obligations**

Finally, companies tend to overlook the importance of a discussion of liquidity and capital resources. A good discussion focuses on how the company has been able to meet its cash requirements in historical periods through a thorough analysis of the statements of cash flows and how they expect to meet them in the future through a discussion of commitments, debt covenants, and significant contractual obligations.

Specifically, companies should consider including a thorough discussion of the sources and uses of cash and any trends and uncertainties pertaining to such sources and uses. This includes a discussion of operating cash flows that addresses the actual drivers of operating cash flow rather than the line items in the reconciliation from net income to operating cash flow. A discussion of actual cash inflows and outflows also facilitates a discussion of known trends and uncertainties.

Additionally, companies should consider providing insight into their sources and uses of cash going beyond saying that they will meet their needs in the future. In other words, how much of a line of credit will be drawn, how much will be funded from operations, etc? To enhance disclosure, consider explaining the company's use of its facility, whether there is any excess availability during peak borrowing situations, any uncertainty regarding access to the facility (whether due to market or company specific conditions), and the implications of not being able to access it.

In the past year, an increasing number of companies have concluded that there is substantial doubt regarding their ability to continue as a going concern. In such cases, it should explain the circumstances that have created the issue and any expectations or plans to resolve the going concern issue or at least improve the situation.

If there is a reasonable likelihood that the company may default on material covenants, consider discussing that likelihood (including disclosure of the metric and how the company currently compares) as well as whether the company can avoid or cure the future default. The company also should consider addressing whether the defaulted debt can be refinanced and identify any cross-default provisions or other significant implications.

Finally, to the extent that there are any contractual restrictions limiting the ability of any subsidiary to transfer cash to its parent, you might explain how the restrictions limit the ability to transfer funds to its parent and the impact the restrictions have had and are expected to have on the parent's ability to meet its cash obligations.

Reverse Mergers & “Back Door” Registrations

What is a “back door” registration?

Frequent Areas of Comment:

- ❖ **Required Form 8-K items not filed**
 - **Including Item 4.01 Form 8-K (Change in Accountants)**
- ❖ **Form 10-type information in Form 8-K**
 - **Financial Statements due within 4 business days (no 71-day extension)**
- ❖ **Financial statement updates on Form 8-K**
 - **Interpretation of Exchange Act Rule 13a-1**
- ❖ **Internal Control over Financial Reporting**
 - **Regulation S-K Compliance and Disclosure Interpretation 215.02**

“Back door” registration refers to a private operating company merging with a public shell, thereby gaining the ability to issue public stock. This method of registration is reported on a Form 8-K rather than a 1933 Act registration statement. There are several accounting and reporting complexities with these transactions. They can be more problematic in the review process because they have already been reported and consummated, therefore amendments or changes can be more complicated and burdensome compared to resolving comments on the review of a pre-effective registration statement.

Unless the same audit firm audited both the registrant and the accounting acquirer, a reverse merger always results in change of accountants for purposes of Item 4.01 of Form 8-K.

Item 9.01(c) of Form 8-K indicates that financial statements for reverse mergers with public shells must be filed within four business days and the 71 day extension under Item 9.01 for Rule 3-05 financial statements does not apply. If these are not filed within the four day deadline, registrant may not be considered current or timely for the purposes of using certain forms. Additionally, that Form 8-K is required to include all the disclosures that the operating company or accounting acquirer would be required to present in a registration statement on Form 10.

When the 8-K is filed shortly after year end or quarter end, the most recent year end or quarter end is generally not included in the financial statements. Exchange Act Rules 13a-1 and 13a-13 are designed to prevent a gap in reporting after a conventional IPO by requiring the filing of an annual or quarterly report that includes the most recent year or quarter end. Keep in mind that the basic requirement for the 8-K is to provide all the content required by a Form 10 registration statement. Similarly, an accounting acquirer should not have a gap in reporting after a merger with a shell company. Therefore, CF Staff has advised registrants to file an amended 8-K within the same timing as the periodic report would be due to provide updated financial statements.

While the historical financial reporting for pre-transaction periods may change to that of the operating company once the transaction has occurred, the legal issuer has not changed in this transaction and therefore is not a newly public company for purposes of Sarbanes-Oxley Act Section 404. However, CF Staff has issued a C&DI to provide guidance to companies who find themselves in this situation. It acknowledges that it might not always be possible to conduct an assessment of the private operating company or accounting acquirer’s internal control over financial reporting in the period between the consummation date of a reverse acquisition and the date of management’s assessment of internal control over financial reporting required by Item 308(a) of Regulation S-K. It also recognizes that in many of these transactions, such as those in which the legal acquirer is a non-operating public shell company, the internal controls of the legal acquirer may no longer exist as of the assessment date or the assets, liabilities, and operations may be insignificant when compared to the consolidated entity. Therefore, CF Staff does not object if the surviving issuer excludes management’s assessment of ICFR in the Form 10-K covering the fiscal year in which the transaction was consummated. However, we do not believe that companies should take advantage of this C&DI if they had to file an amended Form 8-K under the 13a-1 interpretation discussed above.

Reverse Mergers & “Back Door” Registrations

Illustration of Interpretation of Rule 13a-1

- ❖ Reverse Merger occurs in January 2009
- ❖ Both the public shell company (accounting acquiree) and nonpublic operating company (accounting acquirer) have calendar year-ends
- ❖ 12/31/08 Form 10-K would include the financial statements of the public shell company
- ❖ Financial Statements of the operating company included in the Form 8-K would only include 12/31/07 audited financial statements and 9/30/08 unaudited interim financial statements
- ❖ 3/31/09 Form 10-Q would include financial statements of the operating company
- ❖ *Issue* – The 12/31/08 annual financial statements of the operating company were never filed
- ❖ *Solution* – File an amended Form 8-K containing all information that would be required had the operating company filed a 12/31/08 Form 10-K
- ❖ *NOTE:* Both 2008 and 2009 Forms 10-K would need to comply with SOX 404 requirements

Reverse Mergers & “Back Door” Registrations

- ❖ **Accounting acquirer’s audited F/S presented for all historical periods in subsequent reports**
 - **Earnings per share recast to reflect exchange ratio**
 - **Eliminate retained earnings of shell or legal acquirer**
 - **Common stock of shell or legal acquirer continues**
- ❖ **Audit Issues**
 - **PCAOB Standards**
 - **Domestic auditors of foreign operating companies**

Under current accounting literature, the acquisition of a private operating company by a non-operating public shell is considered by the CF Staff to be a capital transaction in substance rather than a business combination (it is outside the scope of FASB ASC Topic 805). That is, the transaction may be viewed as a reverse recapitalization -- issuance of stock by the private company for the net monetary assets of the shell corporation accompanied by a recapitalization.

As it relates to audit issues, the audit requirements will depend on whether the registrant is a public shell or public operating company. In situations in which the registrant is a public shell requiring the Form 10-level disclosure in the 8-K, the financial statements must be audited by a PCAOB registered firm and audited in accordance with PCAOB standards. When the registrant is an operating company, the accounting acquirer’s financial statements are being presented under Rule 3-05 which would not require a registered firm or an audit in accordance with PCAOB standards. However, it is important to note that since those financial statements will become the financial statements of the registrant they must be in accordance with PCAOB standards when included in the next Form 10-K and any new audit work must be performed by a registered firm.

Finally, CF Staff has been seeing many situations in which the accounting acquirer is foreign company; however, the audit has been performed by a domestic firm. The CF Staff may issue comments on the ability of the domestic firm to perform fieldwork on the foreign company in light of the distance and language barriers. To the extent that the domestic firm has relied on a firm overseas, it may raise questions about the registration of the foreign firm if it has played a substantial role in the audit as defined by the PCAOB and even whether the domestic firm is in fact the principal auditor.

Business Combinations

Separate Financial Statements of an Acquired Business

- ❖ **Rule 3-05 versus Rule 8-04 of Regulation S-X**
- ❖ **Determining Significance**
- ❖ **Periods Presented**

Predecessor Financial Statements

- ❖ **Registrant succeeds to substantially all of the business of another entity**
- ❖ **Registrant's own operations are relatively insignificant**
- ❖ **Financial statements**
- ❖ **Common in SPAC mergers**

The threshold question when reviewing disclosures related to a business combination is “Is the transaction an acquisition of a business or assets?” Rule 11-01(d) of Regulation S-X defines a business for determining when separate financial statements are required to be filed with the SEC. The principle in the rule is whether there is sufficient continuity so that pre-acquisition financial statements would be meaningful. The application of Rule 3-05 compared to Rule 8-04 depends on whether the *registrant* is a smaller reporting company, not on whether the target would qualify as a smaller reporting company. Under Rule 8-04 there is no requirement to provide more than two years audited financial statements for the target. Under Rule 3-05, a third year is required if the transaction was greater than 50% significant and the target had revenues of at least \$50 million in its most recent year. CF Staff may request to see calculations of significance tests in its comments to verify that the correct periods have been presented. Subsequent to the consummation of the merger, the registrant continues to qualify as a smaller reporting company until the next determination date

The assessment of whether predecessor financial statements are required is separate from the assessment of the accounting acquirer. In certain cases, a newly formed entity may have a predecessor or an entity with nominal operations that purchases a business for cash also may have a predecessor. When a registrant succeeds to substantially all of the operations of another entity, that entity is the registrant's predecessor. In these situations, audited financial statements of the predecessor and successor are expected to be presented for the periods required in Rule 3-01 and 3-02 of S-X or Rules 8-02 with no lapse in audited periods. In addition, there is also expected to be a management's discussion and analysis covering the financial statements of the predecessor. The CF Staff will request that registrants include the predecessor's financial statements not only at time the transaction is consummated in a registration statement, but also in any subsequent periodic reports until the predecessor periods are no longer covered by the periodic report.

Business Combinations

Purchase Price Allocation

- ❖ **Allocated to all assets and liabilities acquired generally based upon fair value**
 - **Consider all separately identifiable intangible assets**
- ❖ **Fair value of securities issued**

Determination of Accounting Acquirer

- ❖ **Consideration of all factors (par. A11 -- A15 of SFAS 141(R) (ASC 805-10-55-11 to 15))**

Disclosures

The CF Staff may comment on the purchase price allocation, whether it is related to a probable acquisition and included in the notes to pro forma financial information or a consummated acquisition and included in the notes to the financial statements. In general, the CF Staff may request more information in situations where a disproportionate amount of the purchase price is allocated to goodwill. This request is even more likely if descriptions of the transaction indicate that other intangible assets may have been acquired, but no fair value is assigned.

As it relates to any identified intangible assets, the CF Staff may raise questions if companies conclude that acquired intangible assets have indefinite lives when some of the factors in FASB ASC paragraph 350-30-35-3 may be present. The CF Staff may also comment in situations in which a registrant appears to be defaulting to the straight-line method of amortization when there appears to be clear evidence of another pattern in which the economic benefits of the asset are consumed.

See the discussion on the next slide regarding equity transactions for an understanding of the CF Staff's approach to the fair value of the securities issued.

The determination of the accounting acquirer is an area of significant judgment depending on all the facts and circumstances surrounding the transaction. In determining the accounting acquirer, the CF Staff considers all the indicators in FASB ASC 805-10-55-11 through 15. Voting interests (including the impact of in-the-money options) are not determinative. The CF Staff will also want to understand an evaluation of the board representation, continuing management, whether any voting interests hold significant minority interests and relative size among other factors in evaluating the acquirer. We do not consider the evaluation to be a scorecard. We expect management to fully evaluate the indicators considering the disparity between the two parties in each of the factors, the rights of management as compared to stockholders as compared to the board of director, as appropriate, as well as how the individual factors interact with each other.

FASB ASC Section 805-10-50 highlights the required disclosures. The CF Staff will consider compliance with the disclosure requirements during our reviews.

Equity Transactions

Fair Value Determination

- ❖ **If publicly traded in an active market, use quoted market price**
 - **If discounts are appropriate under the circumstances, they should be supported by objective evidence**
- ❖ **If stock not publicly traded in active market**
 - **Contemporaneous equity transactions with third parties**
 - **Fair value of the services or goods provided may be used to measure the transaction, if more reliable**
 - **Consider SFAS No. 157 & FSP SFAS 157-3 and 157-4 – management’s judgment (ASC 820-10-35)**

Disclosure

- ❖ **All major assumptions used to value stock options, warrants and other equity instruments**
 - **Footnotes**
 - **MD&A (critical accounting estimates)**
 - **Sensitivity analysis**

When smaller companies incorrectly determine fair value for equity issued to consummate certain transactions, such as compensation arrangements and business combinations, it can often lead to material misstatements. CF Staff will frequently comment if a registrant has used a value different from quoted market price to value its equity if it is determined that the stock trades in an active market. GAAP does not permit Blockage discounts if using quoted market price. Discounts for trading restrictions may be appropriate in certain circumstances provided they are characteristics of the security and can be supported with objective evidence. If the stock does not trade in an active market, the CF Staff may look to cash transactions with third parties for the same security in close proximity to support fair value or otherwise may consider the fair value of the services and/or goods received if that measure is more reliable. While quoted market price may not be the appropriate measure of fair value in inactive markets, that price should not be ignored when determining fair value. Absent market prices in an active market or other objective measures of fair value, management should use its judgment considering the fair value hierarchy in determining a fair value that is supportable.

Because of the significant impact that fair value determinations can have on the financial statements, it is helpful for registrants provide disclosure surrounding how the fair value was determined and the impact that reasonable changes in assumptions could have on the measure and on the financial statements directly.

Embedded Conversion Options and Freestanding Warrants

Analysis

- ❖ *Is the instrument within scope of SFAS 150 (ASC 480-10-15)?*
- ❖ *Analyze under SFAS 133 (ASC 815) – two routes*
 1. **Freestanding**
 - **Analyze whether a derivative under SFAS 133**
 - **Perform 00-19 (ASC 815-40) and EITF 07-5 (ASC 815-40-15) analysis to see if par. 11a scope exception in SFAS 133 is available**
 - **If scope exception met, account for as equity**
 - **If no scope exception met, and the option meets the definition of a derivative, account for as a derivative liability (SFAS 133/ASC 815)**

It is a complicated path to determine the appropriate accounting for such instruments. This is necessarily an abbreviated outline of a common process for evaluating warrants and conversion options that does not necessarily consider every step that may be required in all facts and circumstances.

Generally, the first step is to determine whether the instrument is within the scope of FASB ASC Topic 480. If the instrument is within the scope of that literature, the instrument should be classified as an asset or liability and measured using the guidance in that literature.

If the financial instrument is a freestanding warrant and is not within the scope of FASB ASC Topic 480, it may be within the scope of FASB ASC Topic 815. If the warrant is indexed to a company's own stock under FASB ASC Subtopic 815-40, companies should evaluate that Subtopic to determine whether the instrument should be classified within equity with no adjustments for changes in fair value or classified as a liability at fair value with adjustments each period.

Embedded Conversion Options and Freestanding Warrants (cont.)

2. Embedded

- **Analyze whether a derivative requiring bifurcation under SFAS 133 (ASC Topic 815) (this often requires performing an EITF 00-19/EITF 07-5 (ASC 815-40) Analysis to see if par. 11a scope exception in 133 (ASC 815-10-15-74) is met for conversion options)**
- **If scope exception is met, no bifurcation required, but consider BCF under EITF 98-5 and 00-27 (ASC 470-20)**
- **If no scope exception is met, and the definition of a derivative is met, account for as a derivative liability (all embedded derivatives should be combined and accounted for as a single compound embedded derivative)**

As it relates to hybrid financial instruments, such as convertible debentures, embedded features must be analyzed under FASB ASC 815-15-25-1 to determine whether they should be bifurcated and accounted for separately under FASB ASC Topic 815 as an embedded derivative. A key component in that analysis is determining whether the embedded feature is clearly and closely related to the host contract. Clearly and closely related features are not bifurcated. If a feature is not clearly and closely related, additional analysis is required to determine whether the feature should be bifurcated. Companies should consider the staff's views in EITF Topic D-109 on determining the nature of the host contract when the hybrid financial instrument is in the form of a share. Understanding the nature of the host contract often is a key component in determining whether an embedded feature is clearly and closely related to its host (for instance, a conversion option into equity shares would often be C&CR to an equity host contract but not C&CT to a debt host contract).

If the embedded feature is not clearly and closely to the host instrument (par. 12a of FAS 133) and the entire hybrid instrument is not accounted for at fair value through earnings (par. 12b of FAS 133), companies should analyze whether the embedded feature would be considered a derivative if it were a freestanding instrument (par. 12c of FAS 133). That requires an evaluation of whether the feature has the characteristics of a derivative (par. 6 – 9 of FAS 133) and whether any scope exception to derivative accounting would be met (par. 10 – 11 of FAS 133).

If an embedded conversion feature is not bifurcated under FASB ASC Topic 815, companies should consider whether there is a beneficial conversion feature to be accounted for under FASB ASC Subtopic 470-20. Whether a feature is bifurcated or not, the company should consider EITF Topic D-98 and ASR 268 if the instrument is redeemable in determining the classification and measurement of the host contract.

Embedded Conversion Options and Freestanding Warrants (cont'd)

Scope of EITF 00-19 (ASC 815-40)

- Applies to all contracts that are indexed to, and potentially settled in a company's own stock (e.g., warrants, many conversion options)
- Paragraphs 815-40-25-7 through 25-35 and 815-40-55-2 through 55-6 do not apply to conventional convertible debt instruments

Common Pitfalls of EITF 00-19 (ASC 815-40)

- Cash settlement provisions
- Required to settle in registered shares
 - Registration Payment Arrangements are accounted for separately under FSP EITF 00-19-2 (ASC 825-20)
- Insufficient authorized shares
- No limit on # of shares to be delivered
- Incorrect conclusion on whether instrument is indexed to a company's own stock (EITF 07-5 / ASC 815-40-15)

Evaluate the provisions of your agreements (Debt, warrant, reg. rights, anti-dilution provisions, etc.) carefully

As discussed on the previous slides, FASB ASC Subtopic 815-40 is instrumental to the analysis of conversion features and other equity indexed share settled features. In the situation of evaluating convertible debt instruments, companies must first determine whether the instrument is a conventional convertible debt instrument, as explained in FASB ASC paragraphs 815-40-25-41 and 25-42. If the instrument is a conventional convertible debt instrument then Paragraphs 815-40-25-7 through 25-35 and 815-40-55-2 through 55-6 do not apply and will not have to be evaluated, but the remaining paragraphs should still be considered.

It is important to note that agreements that contain clauses to adjust the conversion price other than *standard* anti-dilution provisions that apply to *all* shareholders are not considered conventional convertible. This frequently creates problems for smaller companies. Some other common pitfalls that may lead to an embedded derivative needing to be bifurcated and accounted for as a derivative liability are listed on the slide. That staff frequently finds that restatements in this area are commonly the result of companies not carefully considering and evaluating the accounting implications of provisions of their agreement at the time they are negotiating them or when the transaction is completed.

Embedded Conversion Options and Freestanding Warrants (cont'd)

Valuation Issues

- ❖ **Inappropriate model being used to value the bifurcated embedded derivatives**
 - **Black-Scholes may not be appropriate in many situations given complex features and terms of conversion option**
 - **Terms and features not properly defined, identified and disclosed**

In addition to the recognition and presentation issues addressed on the prior slides, the staff may issue comments to understand how derivatives and bifurcated embedded features have been measured. In many cases, there may be multiple embedded features or the features of the bifurcated derivatives may be so complex that a Black-Scholes valuation does not consider all of the terms of the instrument. Therefore, the fair value may not be appropriately captured by simple models. The staff may consider the reasonableness of assumptions and also whether the valuation technique used is appropriate. In some cases, we have found that the issues related to valuation arise from the terms and features not being properly defined or identified when considering the contractual agreements in their entirety. Generally speaking, significant economic characteristics should not be lost or double counted in the process of bifurcating an embedded feature. In other words, the features and terms attributed to the bifurcated embedded feature plus the features and terms attributed to the remaining host contract should “add up” to the total hybrid instrument that is ultimately being accounted for.

Smaller Reporting Company Status

❖ **Transition to Smaller Reporting Company status**

- Public float < \$50 million on last business day of Q2
 - May reflect change immediately in that 10-Q or wait until Q1 of next fiscal year

- If public float = \$0, < \$40 million audited annual revenues
- Still considered an accelerated filer for remainder of year

❖ **Transition to larger reporting company status**

- Public float ≥ \$75 million on last business day of Q2
- If public float = \$0, ≥ \$50 million audited annual revenues
 - May wait until Q1 of next fiscal year

❖ **Form 10-KSB and other SB forms are no longer available (incl. amendments)**

The SEC adopted a new system of disclosure rules for smaller companies filing periodic reports and registration statements effective February 4, 2008. They are scaled to reflect the characteristics and needs of smaller companies and their investors. They replace the disclosure requirements formerly in the SEC's Regulation S-B, which applied to "small business issuers." This slide highlights the tests for transitioning in and out of smaller reporting company status. Some key items to highlight are as follows:

- Unlike Regulation S-B, companies that have a public float need only consider that float in their test. The revenue test only applies to companies with no public float.
- While the thresholds may align with the thresholds for filer status (i.e. nonaccelerated or accelerated), the test is for different purposes and there may be circumstances where a smaller reporting company is an accelerated filer or where a larger reporting company is a nonaccelerated filer.
- The transition rules are structured to be most favorable for companies exiting or entering smaller reporting companies. If a company is required to exit smaller reporting company status, it may continue to report as a smaller reporting company through the filing of the annual report on Form 10-K for that year. If it newly qualify as a smaller reporting company based upon their second quarter public float, it may elect to provide scaled disclosure in its next quarterly report on Form 10-Q.

The SB forms are no longer available for initial filings or amendments. Any company amending a document previously filed on an SB form must now use the regular form. Likewise, any company with delinquent reports that would have been filed on an SB form must now file those reports on a regular form.

Common Comment Areas on Disclosure Controls & Procedures

❖ Conclusions

- Disclosure should state DC&P conclusion in clear and unqualified language – effective or not effective
- “Adequate” or “Effective except for...” are inappropriate
- “Effective” DC&P conclusion when ICFR conclusion is “ineffective”
- Consider reassessing conclusions upon the filing of any amendments

❖ Incomplete definition of DC&P

- If definition is included, should conform exactly to Item Exchange Act Rule 13a-15 (note definition is not required)

CF Staff continues to issue comments on the evaluation of disclosure controls and procedures in quarterly and annual reporting. Item 307 of Regulation S-K requires companies to clearly disclose whether disclosure controls and procedures are effective or ineffective. Registrants should be aware that the definition of disclosure controls and procedures is more broader than the definition of internal control over financial reporting so it is possible that disclosure controls and procedures can be ineffective even while internal control over financial reporting is effective.

However, the CF Staff may be highly skeptical in situations where internal control over financial reporting is ineffective but disclosure controls and procedures are effective. In such situation, we may ask the company to support its conclusion.

Internal Control over Financial Reporting (ICFR)

Management Reports under Item 308(a) of Regulation S-K

- ❖ **Separate evaluation and assessment from evaluation of disclosure controls and procedures**
- ❖ **All four elements in Item 308(a) must be addressed in disclosure**
- ❖ **ICFR cannot be “effective” if material weakness exists**
- ❖ **Clear conclusion (either “effective” or “ineffective”)**

As was mentioned on the prior slide (#36), the conclusions related to internal control over financial reporting are separate and distinct (albeit they may be related) from the conclusions regarding the effectiveness of disclosure controls and procedures. In this regard, the rules require that registrants explicitly state whether internal control over financial reporting is effective or ineffective with no qualifying language or scope limitations. The CF Staff generally asks companies that do not appear to have completed an assessment and/or have not disclosed their conclusion on effectiveness to amend their filings.

From a compliance perspective, companies subject to the auditor attestation requirement must disclose all four elements required by Item 308(a) of Regulation S-K. Similarly, companies not yet subject to that requirement, must disclose the four elements required by temporary Item 308T(a) of Regulation S-K. As it relates to the framework, the Commission specified the characteristics of a suitable control framework and identified the “Internal Control – Integrated Framework(1992)” created by COSO as an example of a suitable framework. The *Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934* or “Management’s Guidance” highlighted two other frameworks that met the characteristics outlined in the adopting release and encourages companies to examine and select a framework that may be useful in their own circumstances. It is important to note, however, that the Management’s Guidance itself is not a framework.

Internal Control over Financial Reporting (ICFR)

Disclosures companies should consider when material weakness exists (see SEC Release No. 33-8810)

- ❖ **Nature of the material weakness**
- ❖ **Impact of control deficiency on the company's financial reporting and its ICFR**
- ❖ **Current plans, if any, or actions already undertaken to remediate the material weakness (note Item 308 (c) of Regulation S-K)**
- ❖ **Disclosures should be detailed and specific for each material weakness identified**

As they relate to both accelerated and nonaccelerated filers, CF Staff continues to comment on and observe areas where disclosures of material weaknesses can be improved. Disclosures of material weaknesses are most useful if they provide some transparency into the pervasiveness and impact a particular material weaknesses could have on the financial statements. Such disclosures may indicate the individual line items that may be impacted by the weakness, the potential magnitude of the impact as well as the likelihood. When evaluating whether deficiencies are in fact material weakness, companies may consider more carefully analyzing the likelihood that the deficiency could fail to prevent a material error.

The CF Staff also often sees material weaknesses that are narrowly focused on one particular financial statement line item in which an error was discovered. For example, a company may disclose that it has material weaknesses related to its accounts receivable. Not only does this disclosure not specifically address the internal controls in which there are the weakness, it does not consider the impact that the weakness could have on other financial statement line items. In other words, the disclosure should not be narrowly limited to the line item in which the error was found. This very issue may also become evident through the remediation disclosures. For example, the remediation disclosures may indicate that the registrant is improving internal controls that go well beyond and impact more areas than the narrow material weakness disclosed.

It can be meaningful if registrants disclose current plans to remediate the weakness and provide disclosures of any changes to internal control over financial reporting as the result of remediation efforts in conjunction with the required disclosures under Item 308(c) of Regulation S-K.

Registrants are required to disclose all material weaknesses identified so companies might consider the above guidance for each material weakness. Likewise, while the thoughts above discuss disclosures that are too narrow, the CF Staff recommends that companies not group multiple material weaknesses into the description of one general material weakness.



Resources

Resources

SEC Website – www.sec.gov

- ❖ **Division of Corporation Finance - www.sec.gov/divisions/corpfin.shtml**
- ❖ **Information for Small Businesses - www.sec.gov/info/smallbus.shtml**
- ❖ **Information for Accountants - www.sec.gov/divisions/corpfin/cfreportingguidance.shtml**
 - **Corporation Finance Filing Review Process -- www.sec.gov/divisions/corpfin/cffilingreview.htm**
 - **Division of Corporation Finance Financial Reporting Manual-- www.sec.gov/divisions/corpfin/cffinancialreportingmanual.shtml**
 - **Corporation Finance Compliance and Disclosure Interpretations-- www.sec.gov/divisions/corpfin/cfguidance.shtml**
 - **Presentation from last year's forums -- www.sec.gov/news/speech/2008/spch111708wc-slides.pdf**
 - **Areas of Frequent Staff Comment —Financial Institutions -- <http://www.sec.gov/news/speech/2009/slides1209slh.pdf>**

Questions???

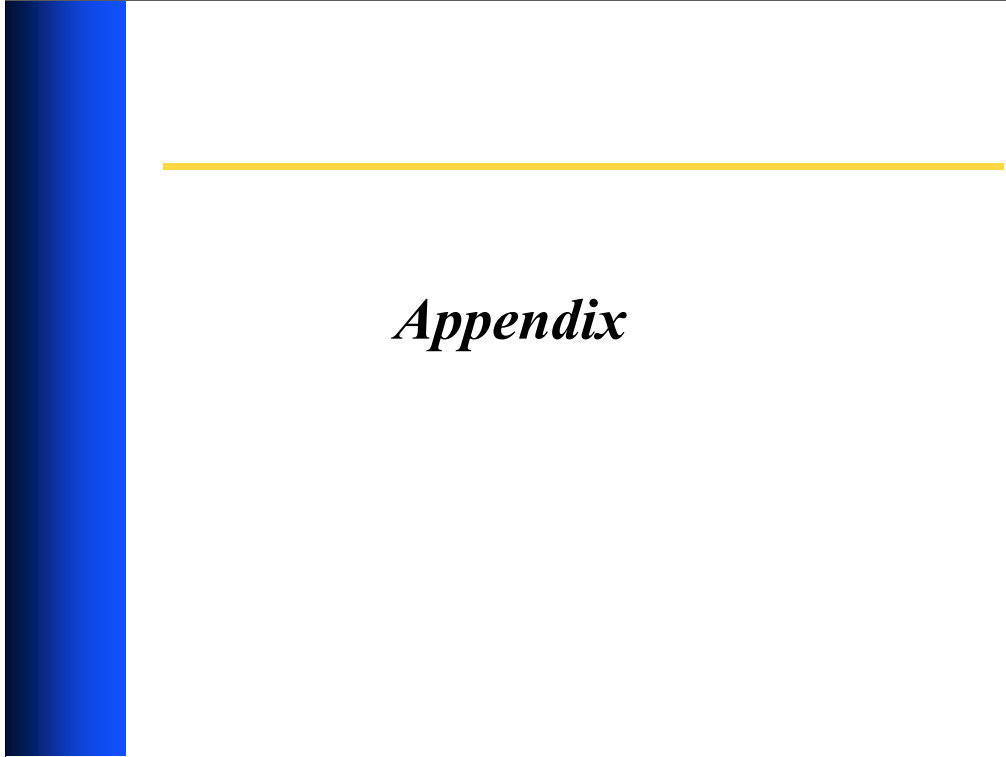
Key Telephone Numbers

Corporation Finance Office of Chief Accountant (202) 551-3400

Corporation Finance Office of Chief Counsel (202) 551-3500

SEC Office of the Chief Accountant (202) 551-5300

Corporation Finance Office of Small Business Policy (202) 551-3460



The following slides were not presented at the forums but included in the materials as a reference for participants. The following slides cover additional areas in which the CF Staff frequently issues comments.

Financial Statement Classification

Registrants that qualify as smaller reporting companies reporting under Article 8 of Regulation S-X

- ❖ **Need not apply the other form and content requirements in Regulation S-X except:**
 - **Report and qualifications of the independent accountant (Article 2)**
 - **Description of accounting policies (Rule 4-08(n))**
 - **Companies engaged in oil and gas producing activities (Rule 4-10)**
- ❖ **Guidance outside of Regulation S-X continues to apply that may result in comments. For example:**
 - **Equity vs. non-equity (EITF Topic D-98/ASC 480-10-S99 and SFAS No. 150/ASC 480-10)**
 - **Operating, investing, and financing cash flows (SFAS No. 95/ASC 230-10)**
 - **Discontinued operations (SFAS No. 144/ASC 360-10)**
 - **Stock-based compensation expense (SAB Topic 14F)**

While smaller reporting companies are not required to adhere to Articles 5, 6, 6A, 7, or 9 on financial statement presentation and classification for specific industries, they must follow the presentation and disclosure requirements of US GAAP and consider related SEC staff interpretations of those requirements.

Financial Statement Classification

Registrants that do not qualify to report under Article 8 of Regulation S-X

- ❖ **Subject to more detailed classification rules (e.g., Article 5 of Regulation S-X for commercial and industrial companies)**
 - **Rule 5-02 - balance sheets**
 - **Rule 5-03 – income statements**
- ❖ **These additional rules most often result in comments relating to Rule 5-03**
 - **Components of revenue**
 - **Cost of sales**
 - **Classification of share-based payments**
 - **Operating vs. non-operating**

Companies that do not qualify as smaller reporting companies must adhere to the classification requirements within Article 5 or the appropriate Article for their industry. For these companies, CF Staff may comment on certain classification issues such as:

- Product and service revenues should be appropriately disaggregated on the face of the income statement if they meet the 10% threshold in Rule 5-03 of Regulation S-X. The CF Staff recommends that Registrants also consider disaggregation if the margin on individual components are so different that they skew the company's margins presented on the income statement.
- Costs of sales should generally include the appropriate allocation of depreciation and all other related costs. If depreciation is not included in costs of sales, companies should clearly indicate that it has been excluded on the face of the income statement and refrain from presenting a measure of gross profit.
- Share-based payments should be classified within the same line item in which cash compensation is classified for a given employee. The CF Staff will not object if companies disclose the amount of share-based compensation within a given line item parenthetically on the face of the income statement or within the notes to the financial statements.
- Finally, the CF Staff may question the appropriateness of certain items that are classified as operating items rather than non-operating and vice versa. The determination should usually be based upon the activity that generated the income or expense. Litigation settlements are one example of an area requiring judgment since they may be classified as operating or non-operating depending on the nature of the litigation.

General Reporting Requirements

Registration Statements - Rule 8-08 of Regulation S-X

- ❖ **Financial statements must be current as of the date of the filing and as of a date fewer than 135 days before the registration statement in which they appear is declared effective**
- ❖ **If the smaller reporting company registration statement's effective date falls after 45 days but within 90 days of the fiscal year end, audited financial statements are not required provided the following:**
 - **If a reporting company, all reports must have been filed**
 - **Company expects to report income from continuing operations before taxes for the most recent year**
 - **Company has reported income from continuing operations before taxes in at least one of the two before the most recent year**

It is important that registrants are mindful of the requirements pertaining to the age of financial statements in a registration statement. Updating financial statements can be time consuming and may slow down a registered transaction considerably if the company does not plan for it appropriately.

Revenue Recognition

Common Areas of Comment

- ❖ **Policy disclosures (i.e., SAB 104)**
 - **Avoid “Boilerplate” disclosures**
 - **Disclosure should be specific to company’s revenue streams**
- ❖ **EITF 00-21 (ASC 605-25) – Multiple-Element Arrangements**
 - **May also relate to separate agreements negotiated together or in close proximity**
- ❖ **EITF 99-19 (ASC 605-45) – Gross versus Net Revenue Recognition**
 - **Consider and weigh all indicators**

CF Staff frequently requests clarification of how companies recognize revenue, including how their revenue recognition is consistent with SAB 104, which provides guidance on how to apply general accepted accounting principles to revenue recognition issues. We also ask companies to expand their revenue recognition accounting policy disclosures. In many cases, these comments are raised because of overly vague or “boilerplate” disclosures provided by the company. Registrants should take care to fully disclose the timing and method for recognizing revenue for each of their material revenue streams.

As it relates to revenue recognition under ASC Subtopic 605-25, the CF Staff frequently comments in situations where it is not clear that deliverables qualify as separate units of accounting or appears that they do not qualify as separate units. In such situations, the CF Staff may ask the registrant how it evaluated each of the criteria to conclude that the delivered item could be considered a separate unit of accounting. With the issuance of ASU 2009-13, we expect multiple deliverables to more frequently qualify as separate units; however, we may be more likely to have comments on the allocation of revenue to the deliverables because of the significant amount of judgment involved.

The CF Staff may comment when companies may recognize revenue on a gross basis and the disclosures raise questions as to whether registrant is really acting as an agent and should be reporting revenue on a net basis. The opposite may occur where revenue is presented on a net basis, but the registrant’s business appears to be more in line with a principal. If there is not transparent disclosure in MD&A or elsewhere as to how the registrant reached its conclusions, the Staff may comment and ask how the registrant has evaluated each of the indicators in ASC Subtopic 605-45, and which specific indicators carry the most weight in their fact pattern.

Pro Forma Information

Consideration of Article 11 of Reg. S-X Adjustments

- ❖ **Directly Attributable**
- ❖ **Have a continuing impact (pro forma income statement)**
- ❖ **Factually supportable**

Examples

MD&A

Article 8 recommends that smaller reporting companies look to Article 11 for guidance in preparing pro forma information. Article 8 specifically requires pro forma information for business acquisitions. Other than acquisitions, pro forma financial information may be appropriate considering the significance of the transaction, the type of filing in which the pro forma financial information will be included, and the overall materiality to an investor. When prepared, pro forma financial information should only reflect adjustments that are directly attributable to the transaction and factually supportable. As it relates to the income statement, adjustments should only be reflected if they will have a continuing impact on the entity.

Some examples are:

- *Non-recurring gains or losses directly attributable to transaction* – Consider including adjustments for pro forma retained earnings on pro forma balance sheet, and describe in footnote to pro forma income statements, but do not adjust on the face of the pro forma income statement since no continuing impact
- *Pro forma statements that give effect to a business combination* – Generally, the two adjustments are
 1. The allocation of the purchase price, including adjusting assets and liabilities to fair value and recognizing intangibles, with related changes in depreciation and amortization expense; and
 2. The effects of additional financing necessary to complete the acquisition. However, other related adjustments may be necessary.

NOTE: CF Staff recommends that registrants use the most recent stock price at the time of filing for determining the value of stock to be issued in a transaction that has not yet consummated.

- Actions to be taken by management subsequent to a business combination may relate to the planned disposal or termination of revenue producing activities, as well as other business integration activities. It may be appropriate to present pro forma adjustments depicting the recurring effects of exiting revenue producing activities if factually supportable.
- CF Staff would expect that contractual terms of the combination such as major new compensation contracts with management be reflected in pro forma adjustments if the new contracts are entered into as part of the acquisition agreement.

Pro Forma MD&A – if there has been a change in basis in the financial statements, such as a material acquisition or predecessor/successor periods (e.g. from push-down accounting), and pro forma information would be meaningful to investors, the CF Staff does not object if companies provide required analysis of results of operations on a historical basis plus an additional analysis of results of operations based on pro forma financial information as long as the pro forma adjustments are transparent. We do not believe it is appropriate to provide an analysis of results based on merely combining the pre- and post-transaction periods in order to get results for a whole year.

Related Party Transactions

Examples of Common Related Party Transactions:

- ❖ **Forgiveness of Debt**
- ❖ **Contributed Services**

Measurement Disclosure

Because many smaller reporting companies are closely held, CF Staff often issues comments pertaining to related party transactions including some of the examples of transactions mentioned on this slide.

CF Staff may issue comments when a gain is recognized upon a related party liability being forgiven. We will seek to understand how the company considered the guidance in FASB ASC paragraph 470-50-40-2.

Normally the CF staff expects financial statements to reflect all costs of doing business (See SAB Topics 1B and 5T), even if some of those costs were paid by related parties such as the parent company.

Any equity issued to a related party for services performed should be reflected at the fair value of the equity issued if readily determinable. See slide on “Equity Transactions” earlier in the presentation.

Related party transactions should be clearly described and impact quantified in footnotes (see FASB ASC paragraph 850-10-50-5). Disclosures should not claim that transactions have been recorded at an arm’s length unless the registrant has objective evidence to support that assertion. If you disclose this, the CF Staff may ask what objective evidence you relied upon.

Form 8-K

Form 8-K interpretations updated on September 14, 2009 at

<http://www.sec.gov/divisions/corpfin/guidance/8-kinterp.htm>

All Item 4.01 and Item 4.02 8-K filings reviewed for strict compliance

Frequent Item 4.01 comments

- ❖ ***Failure to specify whether former accountants resigned, declined to stand for re-election, or were dismissed and the date***
- ❖ ***Exhibit 16 letter***
- ❖ ***Reverse acquisitions***
- ❖ ***Accounting firm mergers***

As mentioned in a prior slide, Form 8-Ks on Items 4.01 and 4.02 are reviewed by the CF Staff.

As they relate to Item 4.01 Form 8-Ks, the CF Staff's comments are generally focused on compliance with the item requirements. They may ask for more information about the facts and circumstances surrounding the change in accountants. The CF Staff may also comment if the Exhibit 16 letter signed by the former accountants has not been filed in a timely manner.

Finally, such Form 8-Ks will usually need to be filed upon the consummation of a reverse merger or upon merger of the registrant's accountants with another firm.

Form 8-K

Most Item 4.02 comments relate to Item 4.02(a)

- ❖ **Triggering event other than non-reliance conclusion (e.g., completion of restatement)**
- ❖ **Unclear statement regarding non-reliance**
- ❖ **Brief description of facts lacking or unclear**
- ❖ **“Stealth restatements”**
 - **See Exchange Act Form 8-K Compliance and Disclosure Interpretation 215.01**

As they relate to Item 4.02 Form 8-Ks, again comments will generally be focused on compliance with the item requirements. Companies should provide a description of the facts and circumstances leading to the restatement, including the triggering event that led to the conclusion. The triggering event should be the conclusion that previously issued financial statements can no longer be relied upon rather than the restatement of those financial statements. Finally, companies should clearly state the periods for which the financial statements can no longer be relied upon and quantify the impact of that determination to the extent known.

Form 8-K allows registrants to disclose reportable items in periodic reports coming due if the event occurs within the four business days of the due date of the periodic report. Therefore, certain companies have been disclosing the non-reliance on previously issued financial statements in the same report (either 10-K or 10-Q) in which they are restating their financial statements. The CF Staff expects registrants to always report the need to restate financial statements under Item 4.02 on Form 8-K rather than in another periodic report. (See Form 8-K interpretations referenced on prior slide)

CEO/CFO Certifications

Certifications should not deviate from specific form and content in Item 601(b)(31)(i) of Regulation S-K

Internal control over financial reporting (ICFR)

- ❖ **SEC Release 33-8238 (June 2003) permitted exclusion of:**
 - **Introductory language in paragraph 4 referring to responsibility for establishing and maintaining ICFR**
 - **Paragraph 4(b) (certifying officer has designed or supervised the design of ICFR)**
- ❖ **Starting with first period in which management is required to assess ICFR, these statements can no longer be excluded**

The certifications required by Section 302 of the Sarbanes-Oxley Act and included as an exhibit to the quarterly reports and annual report cannot deviate in form or content from what is included in Item 601(b)(31)(i) of Regulation S-K.

In the past, changes to the certifications have gone overlooked by management for a period of time. With that experience, the CF Staff would like to remind non-accelerated filers that they should now be including the introductory language in paragraph 4 and paragraph 4(b) in each periodic report since they are now required to comply with Section 404(a) of the Sarbanes-Oxley Act.

Audit Reports

- ❖ ***Auditor must be PCAOB registered firm that meets all of the requirements of Article 2***
- ❖ ***Audit reports must be filed for all financial statements required to be audited***
- ❖ ***If audit report refers to the report(s) of another auditor(s), the registrant must include those reports in the filing***

Audit reports that do not comply with Article 2 of Regulation S-X frequently stop the review of a registration statement and will always generate CF Staff comment. The financial statements of all issuers must be audited by accountants that are registered with the PCAOB and meet the requirements of Article 2 of Regulation S-X. In situations where another firm plays a “substantial role” (as defined in PCAOB Rule 1001(p)(ii)) in the audit of an issuer (e.g. auditing a significant subsidiary), that firm must also be registered with the PCAOB.

Regardless of whether financial statements for a given period was audited by the current auditor or a predecessor auditor, each period for which audited financial statements are included in the filing must have a related audit report included in the filing. In addition, if the audit report refers to the report of another auditor in expressing an opinion, the other auditor’s report must be included in the filing as well.

For the purposes of any registration statement, each and every audit firm that has issued an opinion in an audit report included in the registration statement must consent to the inclusion of that report in the registration statement.