

***CURRENT
DEVELOPMENTS
IN THE
DIVISION OF
CORPORATION
FINANCE***



**National Conference on Current
SEC & PCAOB Developments
December 11, 2007**



Disclaimer

The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. Therefore, the views expressed today are our own, and do not necessarily reflect the views of the Commission or the other members of the staff of the Commission.



Corporation Finance

Overview

Financial Reporting and Disclosure Issues



Corporation Finance

Overview

Craig C. Olinger

Deputy Chief Accountant



Overview

Review Statistics

FYE September 30, 2007

- ❖ **4,600 issuer reviews
(36% of issuers)**
- ❖ **550 IPOs; 150 new 34 Act reviews**
- ❖ **25.5 days average time for initial
comments on registration statements**



Financial Reporting and Disclosure

Interactive Data

XBRL

Joel K. Levine

Associate Chief Accountant



Interactive Data - XBRL

- **Easily searchable and retrievable information.**
- **Analysis of companies of any size and complexity.**
- **Analysis to meet specific needs of investor or analyst.**



Interactive Data - XBRL

U.S. GAAP TAXONOMY

- **A dictionary of financial reporting concepts.**
- **Each concept is an “element.”**
- **Associate (“tag”) each financial disclosure to an element.**



Interactive Data - XBRL

Financial Disclosures To Be Tagged

- **All financial data within the balance sheets, and statements of income, comprehensive income, cash flows, and owners equity.**
- **Each type of footnote.**
- **Specific information within the footnotes.**



Interactive Data - XBRL

Key Characteristics of Ideal Taxonomy

- **Sufficient number of different elements from which to choose.**
- **Each element is unique. No two exactly alike.**
- **An element exists for all the information you want to tag.**



Interactive Data - XBRL

Extending the Taxonomy with Your Own Customized Elements

- **Allows a company to tag any information it wants without being limited to using elements included in the taxonomy.**
- **Diminishes comparability across companies.**



Interactive Data - XBRL

Project to Build a Comprehensive U.S. GAAP Taxonomy

- **Include enough elements to minimize need for extensions.**
- **Include elements for primary financial statements line items and for the footnotes.**



Interactive Data - XBRL

Project to Build a Comprehensive U.S. GAAP Taxonomy (cont)

- **Include elements for commonly reported information incremental to U.S. GAAP requirements.**
- **Include elements for detailed information within the footnotes, as well as for each entire footnote.**



Interactive Data - XBRL

XBRL Preparers Guide

- **Gives practical guidance for individuals tasked with tagging a set of financial statements.**
- **Promotes consistent tagging.**
- **Promotes comparability of tagged data (and, consequently, data analysis) across companies.**



Interactive Data - XBRL

Preparers Guide – Broad Range of Topics

- **Taxonomy organization**
- **Creating and reviewing instance documents**
- **Finding elements and creating extensions**
- **Changing labels**
- **Contexts**
- **Dimensions**
- **Validation**
- **Rendering**



Interactive Data - XBRL

- For public review and comment of the U.S. GAAP Taxonomy and the Preparers Guide, go to website <http://usgaap.xbrl.us>.
- Provide feedback to XBRL-US, preferably by using the web-based forms on their website.



Interactive Data - XBRL

- **Staff to make recommendations to the Commission about how to deliver maximum benefit of tagged data to investors.**
- **Recommendations expected to be considered by the Commission next spring.**



Interactive Data - XBRL

Areas for Consideration

- Voluntary or required
- Implementation phase-in
- Filed or furnished
- XBRL data with or without ASCII/HTML doc
- Level of footnote tagging
- Extensions
- Management certification
- Third-party assurance



Financial Reporting and Disclosure

- ❖ **Consents & Experts**
- ❖ **Presentation of Change from Consolidation to Equity Method**
- ❖ **MD&A Disclosures in Current Credit Environment**

Stephanie L. Hunsaker
Associate Chief Accountant



Consents & Experts



Consents & Experts

Periodic Reports – '34 Act

•No requirement to obtain consent from expert

◆ However.....

If there is a reference to valuation firm or other expert, registrant must name the expert



Consents & Experts

Registration Stmt – '33 Act

- ❖ **Rule 436 of Regulation C - provides that when a registrant in a Securities Act filing quotes or summarizes a report or opinion of an expert, the registrant must file as an exhibit the expert's written consent to the inclusion of the quotation or summarization in the registration statement.**



Consents & Experts

Q: When is a Consent Required in '33 Act Filing?

A: Any time registrant makes reference to a valuation report obtained from a third party



Consents & Experts

Q: Does management have to reference the independent valuation firm or other expert when it obtains a report from the firm?

A: No – there is no requirement to reference the report from the expert. Management can simply take responsibility for the valuation and not make reference to the expert



Consents & Experts

Example #1

“based upon a valuation prepared by management, with the assistance of an independent third-party”

Is Consent Required?

YES



Consents & Experts

Example #2

“In valuing the asset, management considered the discounted cash flow analysis it prepared, recent sales of similar assets, and a report prepared by independent valuation firm.”

Is Consent Required?

YES



Consents & Experts

Q: If a consent is required from the valuation firm or other expert, does the firm need to be listed under an Experts section?

A: No



Consents & Experts

Content of Consent

❖ *Okay to state that they don't admit to being an expert*

◆ *BUT.....*

Inappropriate to deny being an expert



Consents & Experts

Content of Consent, cont'd

- **Wording may not attempt to limit liability under Section 7 and 11 of the Securities Act**
 - ❖ **Expert should not include language which attempts to state a legal conclusion as to which party is responsible for which item of disclosure**
 - ◆ **Example: Disclosure that the responsibility of the valuation rests solely with the registrant would not be appropriate**



***Presentation of Change
from Consolidation
to Equity Method***



Consolidation to Equity Method

Examples (both registrants have CY end):

- **Registrant sells 60% of its wholly-owned subsidiary to unrelated third party effective April 1, 2007**

- **Registrant (GP) determines they no longer control the LP due to the granting of substantive “kick-out” rights to LP investors effective August 31, 2007**



Consolidation to Equity Method

Question:

- ***Can you reflect the deconsolidation of the entity from the beginning of the year (retroactive equity method application), or only from the effective date of the deconsolidation?***



Consolidation to Equity Method

- ***Par. C2.b of SFAS 144 deleted par. 12 of ARB 51***

- ***Par. 12 of ARB 51:***

“Where the investment in a subsidiary is disposed of during the year, it may be preferable to omit the details of operations of the subsidiary from the consolidated income statement, and to show the equity of the parent in the earnings of the subsidiary prior to disposal as a separate item in the statement”



Consolidation to Equity Method

- ***As a result of SFAS 144 – retroactive application of equity method to beginning of year no longer permitted by GAAP***
 - ❖ **No explanation for change in SFAS 144 change not in original Exposure Draft**

- ***Staff’s longstanding position no longer applicable***
 - ❖ **Position stemmed directly from par. 12 of ARB 51**



Consolidation to Equity Method

- ***Improper retroactive application of equity method to beginning of the year is technically an error***
 - ❖ **Analyze SAB 99 when evaluating whether restatement is necessary**



MD&A Disclosures in the Current Credit Environment



GAAP Disclosure Requirements

- ***SFAS 107***
- ***SFAS 157***
- ***SFAS 115***
- ***EITF 03-1***
- ***SFAS 133***
- ***SOP 94-6***
- ***FSP SOP 94-6-1***
- ***SOP 01-6***
- ***SFAS 5***
- ***FIN 45***
- ***FIN 46R***



MD&A Disclosures in Current Credit Environment

Item 303 – Disclosure required if off-balance sheet arrangements (OBSA) are reasonably likely to have current or future effect that is material on registrant's:

- ❖ **Financial condition, or changes in financial condition,**
- ❖ **Revenues or expenses,**
- ❖ **Results of operations,**
- ❖ **Liquidity,**
- ❖ **Capital expenditures, or**
- ❖ **Capital resources**



MD&A Disclosures in Current Credit Environment

OBSA Disclosures Required

- ❖ **Nature and business purpose**
- ❖ **Importance to registrant in respect of liquidity, capital resources, market risk support, credit support, other benefits**
- ❖ **Amounts of revenues and expenses and cash flows arising from such OBSA**
- ❖ **Nature and amounts of retained interests, securities issued, indebtedness incurred in connection with OBSA**



MD&A Disclosures in Current Credit Environment

OBSA Disclosures Required *(cont'd)*

- ❖ **Nature and amount of any other obligations or liabilities arising from OBSA that are reasonably likely to become material, and triggering events or circumstances that could cause them to arise**
- ❖ **Any known event, demand, commitment, trend or uncertainty that will result or is reasonably likely to result in termination, or material reduction of OBSA that provides material benefit to registrant, and mgmt's reaction in such circumstance**



MD&A Disclosures in Current Credit Environment

OBSA Disclosure Suggestions (not all inclusive):

- ❖ **Categories and rating of assets held in the off-balance sheet entity (OBSE);**
- ❖ **Weighted-average life of assets held in the OBSE;**
- ❖ **Forms of funding (commercial paper, medium-term notes, etc) and weighted-average life of the funding held in the OBSE;**
- ❖ **Any difficulties experienced by the OBSE in issuing commercial paper or other financing;**
- ❖ **Any material write-downs or downgrades of assets held by the OBSE;**



MD&A Disclosures in Current Credit Environment

OBSA Disclosure Suggestions *(cont'd)*

- ❖ **Maximum limit of losses to be borne by any first loss note holders;**
- ❖ **Types of variable interests held in the OBSE;**
- ❖ **Whether the registrant purchased commercial paper or other securities from any OBSE they manage, and whether the purchases were required under any agreement. If not, consider disclosing the reasons for the purchase;**



MD&A Disclosures in Current Credit Environment

OBSA Disclosure Suggestions *(cont'd)*

- ❖ **More disclosure about the registrant's obligations under any existing liquidity facilities or written put options**
 - ◆ **Funding triggers,**
 - ◆ **Terms limiting obligation to perform,**
 - ◆ **Nature of obligations under the facilities (purchase CP or assets and at what price),**
 - ◆ **Ranking of registrant's obligations with any other liquidity providers.**



MD&A Disclosures in Current Credit Environment

OBSA Disclosure Suggestions *(cont'd)*

- ❖ **Whether registrant provided or assisted the OBSE in obtaining any other type of support, or has current intentions to do so;**
- ❖ **Potential impact on debt covenants, capital ratios, credit ratings, or dividends, should consolidation be required, or if registrant incurs material losses associated with the entity.**



MD&A Disclosures in Current Credit Environment

Critical Acct Estimates - Disclosure Suggestions *(cont'd)*

- ❖ **Scenarios where the registrant would have to consolidate the off-balance sheet vehicle, and the registrant's expectation of the likelihood of such consolidation;**
- ❖ **Disclosure regarding the frequency of which the registrant reconsiders, and the typical triggers which require the registrant to reconsider, whether it is the primary beneficiary of the entity;**



MD&A Disclosures in Current Credit Environment

Other Disclosure Suggestions (cont'd)

- ***Item 303 – requirement to disclose any known trends or uncertainties that you may reasonably expect to have a material impact on income, liquidity or capital resources***
- ❖ **Consider disclosing, to the extent material, amount of loss the registrant expects to realize as a result of its involvement with the OBSE**



MD&A Disclosures in Current Credit Environment

OBSA Disclosure

- ❖ **Judgment in determining level of disclosure – the more material the exposure, the more likely additional disclosure would be beneficial**
 - ◆ **Ex: If you have risk factors about OBSE, will likely need more disclosure than the bare minimum disclosures outlined in Item 303**
- ❖ **Disclosures could be aggregated among the different material OBSEs to the extent they are comparable**



MD&A Disclosures in Current Credit Environment

Critical Accounting Estimates (CAE)

- ***Many registrants with significant financial instruments identify fair value determination as significant CAE***
 - ❖ **Some disclosures not very insightful – don't provide insight into types of models or assumptions**



MD&A Disclosures in Current Credit Environment

Examples:

- ❖ **Just stating that fair value determination requires more judgment and is more subjective where market data is not available**
- ❖ **Just stating the use of proprietary models, simulation techniques, or closed-form analytic formulae, without describing key inputs to these models, and related assumptions for the inputs**



MD&A Disclosures in Current Credit Environment

CAE Disclosure Suggestions – FV

- ❖ **Types of models used in these situations**
- ❖ **Significant inputs into the models (especially highlighting those with greatest potential to impact the value derived)**
- ❖ **Disclosure of the assumptions for the most significant inputs**
- ❖ **Whether and how those assumptions have changed from prior periods and, if so, why**



MD&A Disclosures in Current Credit Environment

Other Disclosure Suggestions

Reclasses between Level 2 and Level 3 (SFAS 157 disclosures)

- ◆ **If material reclasses – disclose the nature of the inputs that were no longer observable**
- ◆ **Consider need to discuss techniques being used to determine FV in light of the reclass to Level 3**



MD&A Disclosures in Current Credit Environment

Other Disclosure Suggestions *(cont'd)*

“Maximum Exposure” Disclosure (req. by par. 24c of FIN 46R)

- ❖ **Indicate what the maximum loss number incorporates –potential losses associated with on-balance sheet assets + off-balance sheet exposures (i.e. unfunded liquidity commitments, derivatives, guarantees) – quantify maximum loss for each exposure**
- ❖ **Describe what would need to happen to incur maximum loss**



Financial Reporting and Disclosure

- ❖ **Pro Forma MD&A**
- ❖ **Section 404 Implementation Issues**

Steven C. Jacobs

Associate Chief Accountant



***Management's Discussion
and Analysis of Results of
Operations on a Pro Forma
Basis***



Pro Forma MD&A

- ***Item 303 of Regulation S-K requires discussion of results of operations to cover three-year period included in the financial statements***
 - ❖ **Analysis must be of the financial statements included in the filing**



Pro Forma MD&A

- ***Examples where pro forma MD&A may be meaningful***
 - ❖ Large business combination
 - ❖ Change in registrant's basis due to push-down accounting or EITF 88-16 transaction.
- ***Considerations***
 - ❖ Impact of transaction on an analysis of results
 - ❖ Nature of pro forma adjustments
 - ❖ Overall relevance of supplemental discussion



Pro Forma MD&A

- ***Must be prepared in accordance with Article 11***
 - ❖ **Should *only* reflect the impact of the transaction that benefits from supplemental discussion**
 - ❖ **Most recent fiscal year and interim period only**
 - ◆ **Can carry those periods forward to subsequent periodic reports if meaningful**



Pro Forma MD&A

- ***Disclosures***

- ❖ **How pro forma presentation was derived**
- ❖ **Why management believes that such presentation and discussion is meaningful**
- ❖ **Potential risks associated with using such presentation and discussion**
- ❖ **Pro forma income statement with adjustments must be included if not already included in the filing**



Section 404 Implementation Issues



Section 404 Implementation Issues

- ***Companies seeking any relief not **specifically** addressed through rulemaking or staff guidance must write in with facts and circumstances***
 - ❖ **Submission should be sent to Division of Corporation Finance Office of the Chief Accountant and Office of Chief Counsel**
 - ❖ **No bright lines**
 - ❖ **Determinations based upon individual facts and circumstances**



Section 404 Implementation Issues

- ***SEC Release No. 33-8760 (December 2006) granted one-year transition period for newly public companies***
- ***Instruction 1 to Item 308T of Regulation S-K:***
 - ❖ ***A registrant need not comply with paragraph (a) of this Item until it either had been required to file an annual report pursuant to section 13(a) or 15(d) of the Exchange Act (15 U.S.C. 78m or 78o(d)) for the prior fiscal year or previously had filed an annual report with the Commission for the prior fiscal year...***
- ***Operating companies consummating a reverse merger are NOT “newly public companies”***



Section 404 Implementation Issues

- ***September 24, 2007 Frequently Asked Questions Document, Question #3***
 - ❖ **Exclusion of acquired company from management's assessment of internal controls over financial reporting**
 - ❖ **"...we would typically expect management's report on internal control over financial reporting to include controls at all consolidated entities. However, we acknowledge that *it might not always be possible* to conduct an assessment of an acquired business's internal control over financial reporting in the period between the consummation date and the date of management's assessment. *In such circumstances...*"**
 - ❖ **Did not contemplate reverse mergers**



Section 404 Implementation Issues

- ***Other considerations for relief***
 - ❖ **Timing of transaction consummation**
 - ❖ **Integration of internal controls**
 - ❖ **Changes in internal control environment**
 - ❖ **Changes in management**
 - ❖ **Relevance when considering significance to financial statements**



Section 404 Implementation Issues

•Disclosures

- ❖ **Can only exclude disclosure controls and procedures for Item 307 purposes that are also internal controls over financial reporting**
- ❖ **Clearly state what is included and excluded in assessment**
 - ◆ **Including significance to consolidated financial statements**



Section 404 Implementation Issues

•Disclosures

- ❖ **If not completed for any other reason:**
 - ◆ **Describe transactions**
 - ◆ **Tell readers why assessment was not practicable and/or meaningful**
 - ◆ **What is being done to prepare for next year**
- ❖ **Changes in Internal Control over Financial Reporting (Item 308(c) of Regulation S-K)**
- ❖ **Paragraph 4(b) and related introductory language in Section 302 Certifications**



Financial Reporting and Disclosure

- ❖ **Large Errors RESTATED**
- ❖ **Judgment and the Corporation
Finance Review Process**

Todd E. Hardiman

Associate Chief Accountant



Can a Large Error be Immaterial?



Large Errors **RESTATED**

- ***The Mistake:***

- ❖ **The Regulatory Mindset - Caveats**

- ***The Correction:***

- ❖ **A Large Error Can be Immaterial**



Large Errors RESTATED

Supreme Court

A fact is material if there is a substantial likelihood that the ... fact would have been viewed by the reasonable investor as having significantly altered the “total mix” of information made available.



Large Errors **RESTATED**

Accountant's Quantitative Bias:

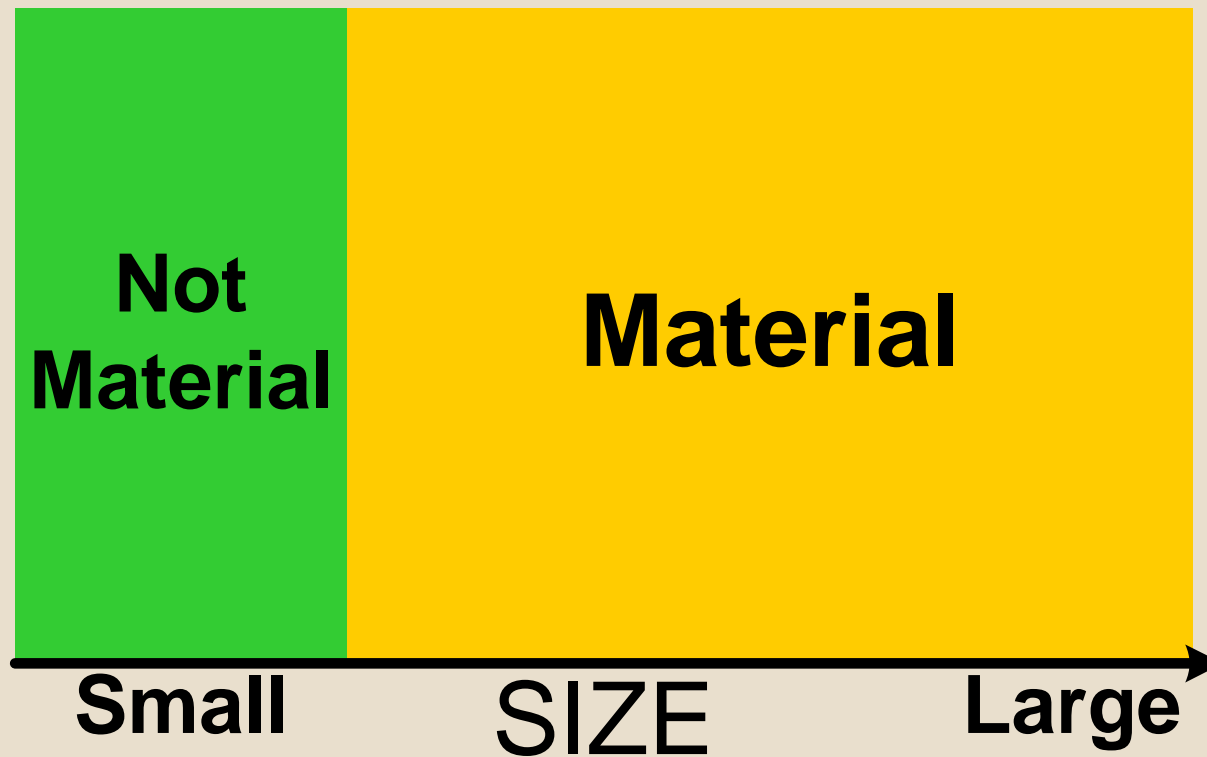
- ❖ ***All Things being Equal, Large Errors are More Important than Small Errors***





Large Errors **RESTATED**

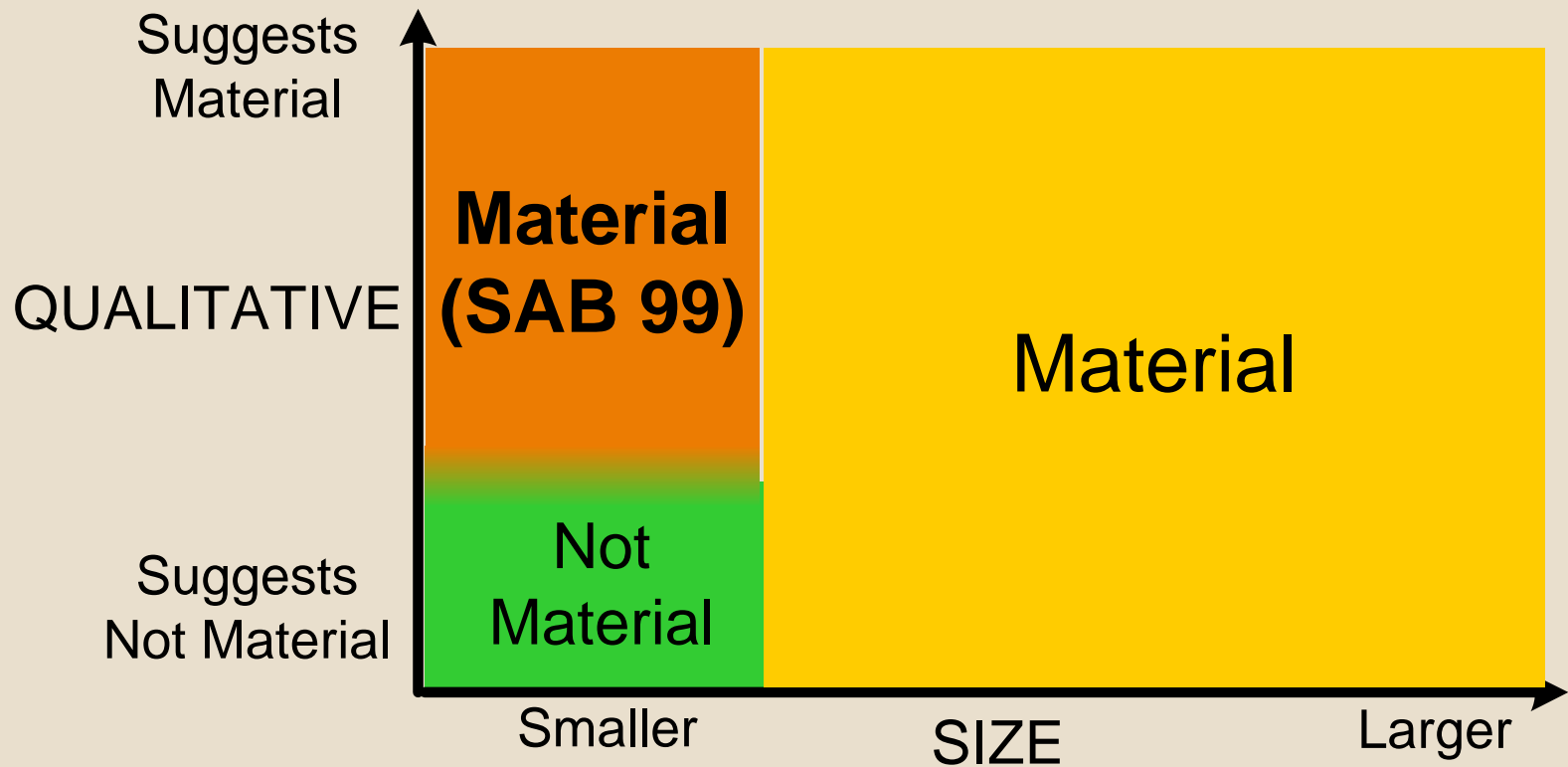
Accountant's Two Dimensional Bias





Large Errors **RESTATED**

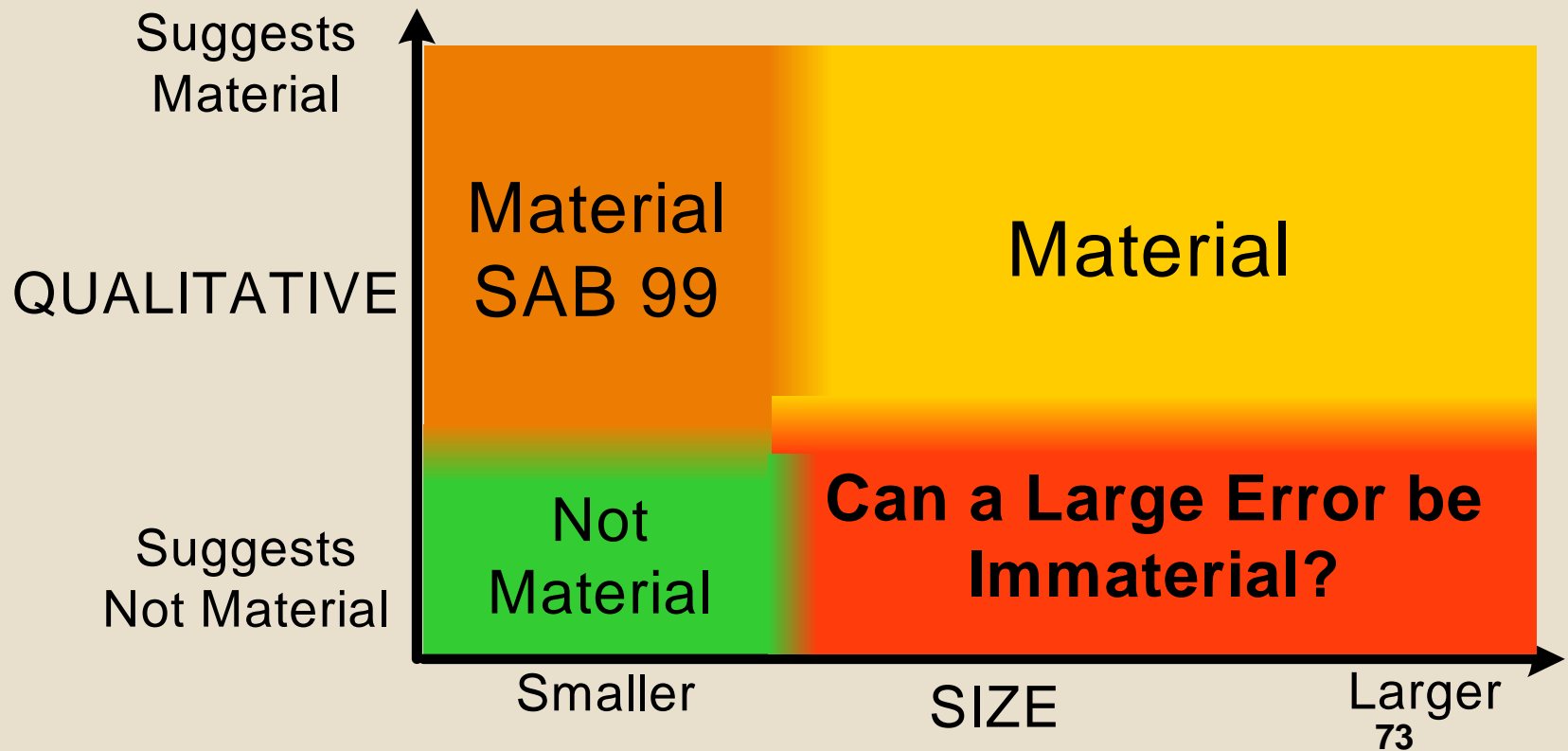
Accountant's Three Dimensional Bias





Large Errors **RESTATED**

Can qualitative factors cause a large error to be immaterial?





Large Errors **RESTATED**

Is there a substantial likelihood that the size of the error would have been viewed by the reasonable investor as having significantly altered the “total mix” of information made available?



Large Errors **RESTATED**

202.CALLSEC



Large Errors RESTATED

- ◆ *Why doesn't the size of the error matter to the reasonable investor?*
- ◆ *What qualitative factors exist that makes the size of the error unimportant?*



Large Errors **RESTATED**

Don't Assume, Talk to Us

***Division's Chief Accounting
Office***

◆ 202.551.3400



Judgment and the Corporation Finance Review Process



Judgment

***Reasonable Judgment
is the
Foundation of our Financial
Reporting System***



Judgment

Examples of Judgment

- ❖ **Rules- Based Standards**
- ❖ **Objectives-Oriented Standards**
- ❖ **No literature on point**



Judgment

- ***When does Division's Staff question?***
- ***What does it mean?***
 - ❖ **Comment – An Invitation to Dialogue**
- ***Threshold = Unreasonable?***



Judgment

- **Who Should Company Talk to if They Disagree with Division Staff's Decision?**
 1. ***Division's Staff Accountant and Review Accountant***
 2. ***Senior Assistant Chief Accountant***
 3. ***Division's Office of Chief Accountant***



Conclusion

Questions

