

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



**National Conference on Current  
SEC & PCAOB Developments  
December 6, 2005**



# *Disclaimer*

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# *Corporation Finance*

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## **Overview**

## **Financial Reporting and Disclosure Issues**



# *Corporation Finance*

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## **OVERVIEW**

**Craig Olinger**



# *Overview*

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**FYE September 30, 2005**

**Over 6000 issuer reviews  
(51% of issuers)**

**26.1 days average time for initial  
comments on registration statements**



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# *Overview*



# *Overview*

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## ***AD Offices - 4 New ACAs***

**Structured Finance, Transportation & Leisure:**

***Lyn Shenk***

**Financial Services**

***Amit Pande***

**Electronics & Machinery**

***Kate Tillan***

**Telecommunications**

***Ivette Leon***



# *Overview*

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## 11 New Accounting Branch Chiefs

Health Care & Insurance

***Kevin Woody***

Consumer Products

***Will Choi***

Natural Resources & Food

***Karl Hiller***

***April Sifford***





# *Overview*

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## **New Accounting Branch Chiefs**

Manufacturing & Construction

***Nilima Shah***

Financial Services

***Joyce Sweeney***

Real Estate & Business Services

***Steven Jacobs***

***Cicely Luckey***



# *Overview*

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## **New Accounting Branch Chiefs**

Emerging Growth Companies

*Terence O'Brien*

Electronics & Machinery

*Angela Crane*

*Michele Gohlke*



# *Corporation Finance*

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## **Financial Reporting and Disclosure Issues**



# *Financial Reporting and Disclosure*

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- ❖ **Accelerated Filer Proposal**
- ❖ **Statement of Cash Flows**

**Joel Levine**



# *Accelerated Filer Proposal*

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## **Proposed Accelerated Filer Rule Amendment**

- ***Computation of public float.***
- ***New category of accelerated filer.***
- ***Modification of accelerated deadlines.***
- ***Ease ability to exit accelerated filer status.***
- ***New cover page disclosures.***



# *Accelerated Filer Proposal*

## **Accelerated Filer – The issuer:**

- ***Has been subject to Section 13(a) or 15(d) of Exchange Act for at least 12 calendar months.***
- ***Has filed at least one annual report under Section 13(a) or 15(d) of the Exchange Act.***
- ***Is not eligible to use forms 10-KSB and 10-QSB.***
- ***Had an aggregate worldwide market value of its voting and non-voting common equity held by non-affiliates of \$75 million or more, but less than \$700 million, as of the last business day of its most recently completed second fiscal quarter.***



# *Accelerated Filer Proposal*

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	<u>Form 10-K</u>	<u>Form 10-Q</u>
<b>Non-accelerated filer</b>	<b>90 days</b>	<b>45 days</b>
<b>Accelerated filer</b>	<b>75 days</b>	<b>40 days</b>
<b>Large accelerated filer</b>	<b>60 days</b>	<b>40 days</b>



# *Accelerated Filer Proposal*

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## **Important Reminders**

- ***Assess and reassess status only at year end.***
- ***Public float is always determined as of the end of the most recently completed second quarter.***
- ***A change in status will impact filing deadlines beginning with the Form 10-K for the year in which the assessment is made.***





# *Accelerated Filer Proposal*

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*A **Large Accelerated Filer** or an **Accelerated Filer** whose public float drops below \$25 million becomes a **non-accelerated filer**, beginning with the 10-K for the year in which the public float was determined.*

*A **Large Accelerated Filer** whose public float drops below \$75 million, but not below \$25 million, becomes an **Accelerated Filer**, beginning with the 10-K for the year in which the public float was determined.*



# *Accelerated Filer Proposal*

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***Cover page to Forms 10-K, 10-Q, and 20-F:***

**Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer.**

**Large accelerated filer** \_\_\_\_\_

**Accelerated filer** \_\_\_\_\_

**Non-accelerated filer** \_\_\_\_\_



# *Accelerated Filer Proposal*

## **Proposed Conforming Amendments**

- *Regulation S-X Rules 3-01, 3-09, and 3-12.*
- *Transition reports filed for change in fiscal year-end under Rules 13a-10 and 15d-10.*

## **Proposed Rule Amendment Release and Comment Letters**

- [www.sec.gov](http://www.sec.gov).
- *Regulatory Actions.*



# *Statement of Cash Flows*

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- ◆ *Increased focus by investors.*
- ◆ *Greater scrutiny in staff reviews.*
  
- **Discontinued operations.**
- **Dealer floor plan financing.**
- **Insurance claim settlement proceeds.**



# *Statement of Cash Flows*

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## **Discontinued Operations**

### **Footnote 10, FASB Statement 95**

**Separate disclosure of cash flows pertaining to discontinued operations reflected in the operating, investing, and financing categories is not required. An enterprise that nevertheless chooses to report separately operating cash flows of discontinued operations shall do so consistently for all periods affected.**



# *Statement of Cash Flows*

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**Key consideration is whether the presentation conforms with the basic disclosure requirement in FAS 95:**

***All cash flows must be reported as either an operating, investing, or financing activity.***



# *Statement of Cash Flows*

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## **Examples:**

- ◆ ***Combine cash flows from discontinued operations with cash flows from continuing operations within each category.***
- ◆ ***Identify cash flows from discontinued operations within each category.***
- ◆ ***Identify cash flows from discontinued operations for each category and present them separately.***



# *Statement of Cash Flows*

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**FAS 95 does not support:**

- ***Aggregating operating, investing, and financing cash flows from discontinued operations into a single line item.***
- ***Presenting operating, investing, and financing cash flows from discontinued operations all within the operating cash flows category.***





# *Statement of Cash Flows*

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**If using the indirect method under FAS 95 – reconcile from net income.**

## **Paragraph 28**

**Entities that choose not to disclose operating cash receipts and payments by the direct method should adjust net income to reconcile it to net cash flow from operating activities (the indirect or reconciliation method).**



# *Statement of Cash Flows*

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## ***MD&A – Liquidity and Capital Resources:***

- ◆ Describe how cash flows from Disc. Ops. are reported in the cash flows statement.
- ◆ Quantify cash flows from Disc. Ops. if not disclosed separately in the cash flows stmt.
- ◆ Describe how the absence of cash flows from Disc. Ops. are expected to affect future liquidity and capital resources. For example, effect on financing levels, terms, covenants, etc.



# *Statement of Cash Flows*

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***Dealer purchases inventory through floor plan financing arrangement with subsidiary of supplier (seller financing):***

- ◆ **Finance subsidiary pays supplier (its parent).**
- ◆ **Finance subsidiary holds lien on inventory.**
- ◆ **Finance subsidiary will be repaid at future date by dealer (generally upon sale to dealer's customer).**



# *Statement of Cash Flows*

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***Dealer reports purchase as increase to inventory and increase to trade loans within operating activities.***

***Repayment is reported as reduction to trade loans within operating activities.***

- **End result – net operating cash inflow for gross profit.**



# *Statement of Cash Flows*

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## ***Third-party financing arrangement:***

- ◆ Finance entity is not affiliated with supplier.
- ◆ Report inventory purchase as operating activity cash outflow and loan as financing activity cash inflow.
- ◆ Reflects substance of financing transaction.
  - End result – net operating cash inflow for gross profit.



# *Statement of Cash Flows*

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## ***Cash flows from insurance proceeds:***

- ◆ **Claim for property damage.**
  - **Is classification affected if proceeds are to be used to repay debt?**
  
- ◆ **Claim for business interruption.**
  - **Is classification affected if proceeds are to be used to buy equipment or settle litigation?**



# *Statement of Cash Flows*

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## **Insurance Proceeds**

### **Paragraph 22c, FASB Statement 95**

**Classify as operating activity proceeds of insurance settlements except for those that are directly related to investing or financing activities, such as from destruction of a building.**



# *Statement of Cash Flows*

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***Report cash flows based on the nature of the insurance coverage (nature of loss).***

- ◆ ***Not impacted by how you spend or plan to spend those proceeds.***

**Business interruption = operating activity.**

**Property damage or loss:**

- ◆ ***PP&E owned or under capital lease = investing activity.***
- ◆ ***PP&E under operating lease = operating activity.***
- ◆ ***Inventory = operating activity.***





# *Statement of Cash Flows*

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***Discuss material settlements in MD&A:***

- ***What you received.***
- ***Why you received it.***
- ***What you plan to do with it.***
- ***Classification in cash flows statement.***
- ***Impact on reported earnings.***



# *Financial Reporting and Disclosure*

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- ❖ **Loans Held for Sale**
- ❖ **Retained Interests in Securitized Loans**
- ❖ **Disclosures about Off-Balance Sheet Arrangements**

**Rachel Mincin**



# *Loans Held for Sale*

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***When should loans and trade receivables be recognized as held for investment instead of as held for sale?***

❖ **SFAS 65**

- ◆ **Scope includes mortgage banking enterprises**

❖ **SOP 01-6**

- ◆ **Scope includes finance companies and entities that do not consider themselves to be finance companies that engage in transactions that involve lending to or financing the activities of others**



# *Loans Held for Sale*

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## *Paragraph .08 of SOP 01-6*

- ❖ **Loans and Trade Receivables are recognized as not held for sale when management has the intent and the ability to hold for the foreseeable future or until maturity**
- ❖ **Once a decision has been made to sell loans not previously classified as held for sale, such loans should be transferred into the held for sale classification**



# *Loans Held for Sale*

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***Loans and trade receivables should be accounted for as held for sale when:***

- ❖ **At origination or purchase management intends to sell the loan / trade receivable in an outright loan sale or in a securitization transaction, or**
- ❖ **Management decides to sell loans or receivables that were initially not classified as held for sale**



# *Loans Held for Sale*

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## *Impact on the financial statements*

- ❖ **Loans HFS reported separately on the balance sheet at the lower of cost or fair value**
- ❖ **Accounting policy disclosure explaining:**
  - ◆ **How the registrant determines that a loan should initially be classified as HFS or later transferred to HFS**
  - ◆ **Method used to determine the lower of cost or fair value for loans / receivable HFS**



# *Loans Held for Sale*

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***Impact on the statement of cash flows depends on:***

- ❖ **Whether the loan or trade receivable results from the sale of the registrant's goods or services**
- ❖ **Whether the loan or trade receivable was initially classified as held for sale or later transferred to held for sale**



# *Loans Held for Sale – Cash Flows*

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***When are loan / receivable cash flows recorded as operating?***

- ❖ **Paragraph 22 of SFAS 95 - cash receipts from the sale of short and long-term notes receivable from customers arising from sales of goods or services are operating**
- ❖ **Paragraph 9 of SFAS 102 - cash receipts and payments resulting from acquisitions and sales of loans that are acquired specifically for resale and are carried at LOCOM should be classified as operating**





# *Loans Held for Sale – Cash Flows*

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***When are loan / receivable cash flows recorded as investing?***

- ❖ **For manufacturing companies only loans that do not result from the sale of inventory to the company's customers that are acquired with the intention of holding for the foreseeable future**
- ❖ **For finance companies all loans that are acquired with the intention of holding for the foreseeable future**



# *Loans Held for Sale – Cash Flows*

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## *Paragraph 9 of SFAS 102*

**“Cash receipts resulting from sales of loans that were not specifically acquired for resale shall be classified as investing cash flows. That is, if loans were acquired as investments, cash receipts from sales of those loans should be classified as investing cash inflows regardless of a change in the purpose of holding those loans.”**



# *Retained Interests in Securitized Loans – Cash Flows*

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***How should the exchange of loans / trade receivables for retained interests in securitized loans impact the statement of cash flows?***

- ❖ **No cash inflows or cash outflows should be reported**
- ❖ **May need to be disclosed as a non-cash investing activity**



# *Retained Interests in Securitized Loans – Cash Flows*

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***When should principal payments received on retained interests be recognized as operating cash inflows?***

- ❖ Only when the retained interests are accounted for like trading securities instead of like AFS or HTM securities**
- ❖ Paragraph 8 of SFAS 102 – cash payments received from securities and other assets should be classified as operating cash flows if those assets are acquired specifically for resale and carried at market value in a trading account**



# *Retained Interests in Securitized Loans – Cash Flows*

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***What is the impact on operating cash flows of acquiring loans for sale in securitization transactions that involve the receipt of subordinate retained interests that are accounted for like AFS securities?***

**❖ Negative operating cash flows**

- ◆ Loan acquisitions are operating cash outflows**
- ◆ Cash proceeds from sale are operating cash inflows**
- ◆ Cash flows from retained interest received as a result of securitization are investing cash inflows**



# *Disclosures about Off-Balance Sheet Arrangements*

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## *Item 303 (a)(4)(ii) of Regulation S-K*

- ❖ Requires disclosure about OBS arrangements in a separately-captioned section in MD&A
- ❖ Requires disclosure about OBS arrangements that management believes are reasonably likely to have a material effect
- ❖ Definition of OBS arrangement focuses on typical transactions in which risk of loss is not fully transparent



# *Disclosures about Off-Balance Sheet Arrangements*

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## *Definition of OBS Arrangement*

- ❖ **Guarantee contracts that are required to apply the measurement provisions of FIN 45**
- ❖ **Retained interest in assets transferred to an unconsolidated entity that serve as credit, liquidity or market risk support to that entity**
- ❖ **Instruments that meet the SFAS 133 definition of a derivative but qualify for the paragraph 11a. scope exception**
- ❖ **Material variable interests held in certain unconsolidated entities**



# *Disclosures about Off-Balance Sheet Arrangements*

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## *Principal Based Disclosure Framework*

- ❖ **Information necessary for an understanding of the OBS arrangement and the material effects**
  - ◆ **Nature and business purpose of the arrangement**
  - ◆ **Importance of the arrangement**
  - ◆ **Financial impact of the arrangement and exposure to risk as a result of the arrangement**
  - ◆ **Known events, demands, commitments, trends or uncertainties that affect availability or benefit of the arrangement**





# *Disclosures about Off-Balance Sheet Arrangements*

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## *Report Pursuant to Section 401(c) of SOX*

- ❖ **The extent of off-balance sheet arrangements including the use of SPEs**
- ❖ **Analyzed data from sample of 200 issuers, the 100 largest issuers and 100 issuers randomly selected**
- ❖ **Reviewed disclosures in 2003 Forms 10-K, including information provided in the Off-Balance Sheet section of MD&A**



# *Disclosures about Off-Balance Sheet Arrangements*

***Data collected from the OBS arrangement section of MD&A***

	Large Issuers	Random Issuers
Guarantees	<b>39%</b>	<b>4%</b>
Retained Interest	<b>14%</b>	<b>0%</b>
Equity-linked Derivatives	<b>2%</b>	<b>1%</b>
Variable Interest Entities	<b>13%</b>	<b>1%</b>



# *Disclosures about Off-Balance Sheet Arrangements*

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## *Observations*

- ❖ **A significant portion of issuers did not have a separately captioned OBS arrangement section in MD&A**
  
- ❖ **Rare for an issuer to discuss an equity linked derivative in the OBS arrangement section**



# *Disclosures about Off-Balance Sheet Arrangements*

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## *Observations (continued)*

- ❖ **Some OBS arrangement section disclosures do not appear complete**
  - ◆ **Retained interest in securitized assets discussed in footnotes, but not OBS section**
  - ◆ **Involvement with VIEs discussed in other portions of MD&A**
  - ◆ **Guarantees included in the contractual obligations table, but not OBS section**



# *Disclosures about Off-Balance Sheet Arrangements*

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## *Room for Improvement*

- ❖ **What was the business purpose for using the OBS entity?**
  - ◆ **Provide financing without having to recognize a liability**
- ❖ **What risks have been transferred and retained as a result of the arrangement?**
- ❖ **What are the factors that impact recognition of contingent obligations or losses related to OBS arrangements?**



# *Disclosures about Off-Balance Sheet Arrangements*

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## *Best Practices*

- ❖ **Descriptions that specifically address your particular circumstances and operations**
- ❖ **Cross references that clearly identify specific information in the footnotes and integrate the substance of the footnotes into MD&A**
- ❖ **When applicable, disclosing that there are no material transactions that meet the Regulation S-K definition of an OBS arrangement**



# *Financial Reporting and Disclosure*

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- ❖ **Segments and Reporting Units**
- ❖ **DCP & ICFR – Reporting Issues**
- ❖ **Valuation Issues**

**Sondra Stokes**



# *Financial Reporting and Disclosure*

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## **Identification of:**

- ❖ **Segments**
- ❖ **Reporting units**





# *Segments*

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## ***FAS 131 Objective (paragraph 3):***

***To provide information about the different types of business activities in which an entity engages and the different economic environments in which it operates to facilitate an understanding of the entity's performance, its prospects for future cash flows and enable a reader to make more informed judgments about the entity as a whole***



# *Segments*

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***How is the objective achieved?***

***Through the use of the management approach – by focusing on information used by an entity’s decision makers when they allocate resources and assess performance***



# *Segments*

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**An operating segment is a component:**

- **That engages in business activities from which it may earn revenue and incur expense**
- **Whose operating results are regularly reviewed by the CODM in making decisions**
- **For which discrete financial information is available**



# *Segments*

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## ***Aggregation of operating segments***

**Should be consistent with the overall objective of FAS 131, possess similar economic characteristics and meet the following criteria:**

- ◆ Similar products and services**
- ◆ Similar production processes**
- ◆ Similar type or class of customer**
- ◆ Similar distribution methods**
- ◆ Similar regulatory environment**



# *Segments*

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## ***Inappropriate aggregation of operating segments***

- ❖ **Aggregating segments that do not meet all of the aggregation criteria including economic similarity**
- ❖ **Aggregating quantitatively immaterial segments with a reportable segment with which it does not share a majority of the aggregation criteria**



# *Segments*

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***Why is it so important to properly identify the operating segments?***

***More than just a disclosure issue***



# *Reporting Units*

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***Required to assess goodwill for impairment under FAS 142 at the reporting unit level***

***An operating segment or one level below an operating segment (component)***



# *Reporting Units*

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***A component is a reporting unit if:***

- ❖ It is a business**
- ❖ Discrete financial information is available**
- ❖ This information is regularly reviewed by segment management**





# *Reporting Units*

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## **Aggregation of components in determining reporting units**

- ❖ **May be appropriate if the components have similar economic characteristic**
- ❖ **Not permitted across operating segments, despite the components sharing similar economic characteristics**



# *Reporting Units*

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## *Disclosure:*

- ❖ Reporting units identified
- ❖ How goodwill allocated
- ❖ Changes in
  - ◆ The number of reporting units
  - ◆ How goodwill was allocated



# *Reporting Units*

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***Improper identification of operating segments means  
A likely misidentification of reporting units which can lead to  
Inappropriate calculations of goodwill impairment charges***



# *Financial Reporting and Disclosure*

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## **Disclosure Controls and Procedures and Internal Control over Financial Reporting Reporting Issues**



# ***DCP & ICFR – Reporting Issues***

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***DCP – Disclosures currently apply to all registrants***

***ICFR - Disclosure applies to:***

- ❖ Accelerated filers –  
FY ending on or after 11/15/04**
- ❖ FPI's who are accelerated filers –  
FY ending on or after 7/15/06**
- ❖ Non accelerated filers (includes SB) –  
FY ending on or after 7/15/07**



# *DCP & ICFR – Reporting Issues*

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**Management must conclude that DCPs are either:**

- ❖ **Effective**
- ❖ **Ineffective**

**Not appropriate:**

- ❖ **“Effective except for”**
- ❖ **“Effective except as disclosed below”**
- ❖ **“Adequate”**



# ***DCP & ICFR – Reporting Issues***

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## ***Disclosure of material weaknesses***

- ❖ **Nature**
- ❖ **Impact on financial reporting and control environment**
- ❖ **Management's remediation plan**
- ❖ **May also need MD&A disclosure**



# *DCP & ICFR – Reporting Issues*

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***If management does conclude that DCP are effective when material weaknesses in ICFR exist –***

***Disclosure is critical:***

- ❖ **Alternate factors relied upon**
- ❖ **Registrant specific – no boilerplate**
- ❖ **Clearly communicate how the conclusion was arrived at**
- ❖ **Tell the whole story**





# *DCP & ICFR – Reporting Issues*

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***Management originally concluded that DCP and ICFR were effective. The registrant is now restating its financial statements due to errors.***

***What is the impact on management's original conclusions on DCP and ICFR?***



# *DCP & ICFR – Reporting Issues*

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***A material weakness in ICFR does not necessarily exist in every case of a restatement related to an error.***

***Look at:***

- ❖ **Why the restatement was necessary**
- ❖ **Whether the restatement resulted from a material weakness in controls**



# *DCP & ICFR – Reporting Issues*

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- ❖ **No specific requirement for the registrant to reassess ICFR to issue a revised management report BUT the registrant may elect to do so**
  - ◆ **Registrant must review and may need to revise original disclosures under Item 308**
- ❖ **Auditor may be required to issue a revised attestation report on the registrant's ICFR as the audit report on the F/S and ICFR must have the same date**



# ***DCP & ICFR – Reporting Issues***

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***Disclosure under Item 307 in the case of a restatement for errors where a material weakness has been identified***

- ❖ **Management must re-evaluate original conclusions on effectiveness of DCP in all amended reports**



# *DCP & ICFR – Reporting Issues*

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***What should be disclosed with respect to ICFR in the Item 4.02 Form 8-K?***



# *DCP & ICFR – Reporting Issues*

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## ***Staff Statement on Management's Report on Internal Control Over Financial Reporting - Issued May 16, 2005***

***[www.sec.gov/info/accountants/stafficreporting.pdf](http://www.sec.gov/info/accountants/stafficreporting.pdf)***

## ***Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Frequently Asked Questions (revised October 6, 2004)***

***[www.sec.gov/info/accountants/controlfaq1004.htm](http://www.sec.gov/info/accountants/controlfaq1004.htm)***



# *DCP & ICFR – Reporting Issues*

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***Overall focus of reporting on ICFR -  
To identify items that could result in  
material errors to the financial  
statements***

***Disclosure is key***



# *Financial Reporting and Disclosure*

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## **Valuation Issues**

- ❖ **Block discounts**
- ❖ **Warrants granted to non-employees**





# *Valuation Issues*

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## *Block Discounts*

***We believe that available quoted market prices are evidence of the fair value of a financial instrument, and that block discounts are not in accordance with GAAP in determining fair value***



# *Valuation Issues*

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## *Block Discounts, continued*

### *Use of quoted market prices*

- ❖ FAS 107, paragraph 5
- ❖ FAS 107, paragraph 58
- ❖ FAS 115, paragraph 3a



# *Valuation Issues*

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## *Block Discounts, continued*

### *Prohibition on block discounts*

- ❖ FAS 107, paragraph 6
- ❖ FAS 115, Implementation Guide, Question 50
- ❖ EITF 98-5, Footnote 3

**Paragraph 28 of 10/21/05 FASB Working Draft on Fair Value Measurements (SFAS No. 15X)**



# *Valuation Issues*

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## *Warrants issued to non-employees*

*How they differ from employee share options –*

- ❖ Typically do not contain transfer restrictions
- ❖ Normally subject to immediate exercise



# *Valuation Issues*

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***Warrants issued to non-employees, continued***

***Footnote 7 of SAB 107***

***“If these features (i.e., nontransferability, nonhedgability and the truncation of the contractual term) were not present in a nonemployee share option arrangement, the use of an expected term assumption shorter than the contractual term would generally not be appropriate in estimating the fair value of the nonemployee share option.”***



# *Valuation Issues*

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***Warrants issued to non-employees, continued***

***If valued using Black-Scholes model***

***Use the contractual term in the calculation,  
not the expected term***



# *Financial Reporting and Disclosure*

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**S O S**

**(.....)**



# *Financial Reporting and Disclosure*

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## ❖ **Embedded Conversion Options and Freestanding Warrants**

➤ **Liabilities or Equity?**

**Todd E. Hardiman**





# *Liability or Equity?*

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***Issue relates primarily to:***

- ❖ **Convertible debt**
- ❖ **Convertible preferred stock**
- ❖ **Freestanding warrants to buy registrant's stock**

***Frequent resolution***

- ❖ **Error correction**



# *Liability or Equity?*

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## ***Applicable Guidance Includes***

### **❖ FASB**

- ◆ APB 14, APB 26, SFAS 133, SFAS 150

### **❖ EITF**

- ◆ EITF 96-19, EITF 98-5, EITF 00-4, EITF 00-6, EITF 00-19, EITF 00-27, EITF 01-6, EITF 03-6, EITF 05-1, EITF 05-2, EITF 05-4, EITF 05-7, EITF 05-8

### **❖ SEC**

- ◆ ASR 268, EITF D-98



# *Embedded Conversion Options Liability or Equity?*

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## *Embedded Conversion Options*

- ❖ **Need to focus beyond intrinsic value**
  - ◆ ***EITF 98-5 - Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios***
  - ◆ ***EITF 00-27 – Application of Issue No. 98-5 to Certain Convertible Instruments***
- ❖ **Address fair value accounting under**
  - ◆ ***SFAS 133 – Accounting for Derivative Instruments and Hedging Activities and***
  - ◆ ***EITF 00-19 – Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, A Company’s Own Stock***



# *Embedded Conversion Options*

## *Accounting for Embedded Conversion Option*

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### **Step 1 – SFAS 133**

- ❖ Evaluate Whether to Separate Embedded from Host (paragraph 12). If met, evaluate:
  - ◆ Scope Exception - paragraph 11a - go to EITF 00-19 if indexed to your own stock

### **Step 2 – EITF 00-19 (Assume indexed to your own stock)**

- ❖ Evaluate whether embedded would be a liability or equity if it were freestanding
  - ◆ Liability – SFAS 133 scope exception NOT met. Separate embedded and account for it at fair value
  - ◆ Equity – SFAS 133 scope exception is met. Evaluate whether embedded has intrinsic value under EITFs 98-5 and 00-27

***CAUTION: Highly Simplified. Also, Assumes SFAS 150 is Not Applicable***



# *Embedded Conversion Options Liability or Equity?*

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## ***Red Flags in Registrant Disclosure***

- ❖ **Solely focused on intrinsic value accounting model in EITFs 98-5 and 00-27**
  - ◆ **No disclosure explaining why conversion option is not a derivative liability that must be fair valued under SFAS 133/EITF 00-19.**
- ❖ **Complex Financings**



# *Embedded Conversion Options Liability or Equity?*

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## ***Restatements - Broad Observations***

- 1. Improper Evaluation of SFAS 133, Paragraph 11a Exception for Fair Value Accounting**
- 2. Result from Undisclosed Features**



# *Embedded Conversion Options Liability or Equity?*

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## *SFAS 133 – Accounting for Derivative Instruments and Hedging Activities*

- ❖ ***Paragraph 11a - Notwithstanding the conditions in paragraphs 6-10, the reporting entity shall not consider the following contracts to be derivative instruments for purposes of this Statement:***
  - a. ***Contracts issued or held by the reporting entity that are both***
    - 1. ***Indexed to its own stock and***
    - 2. ***Classified in stockholders' equity in its statement of financial position***



# *Embedded Conversion Options*

## *Evaluating SFAS 133, 11a scope exception*

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- ❖ **EITF 00-19 – Evaluate whether embedded would be a liability or equity if it were freestanding**
  - ◆ **Liability – SFAS 133 scope exception NOT met. Separate embedded and account for it at fair value**
  - ◆ **Equity – SFAS 133 scope exception is met. Evaluate whether embedded has intrinsic value under EITFs 98-5 and 00-27**





# *Embedded Conversion Options*

## *Evaluating SFAS 133, 11a scope exception*

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### **EITF 00-19, Paragraph 4 (in part) –**

*... The Task Force reached a consensus that for purposes of evaluating under Statement 133 whether an embedded derivative indexed to a company's own stock would be classified in stockholders' equity if freestanding, **the requirements of paragraphs 12-32 of this Issue do not apply if the hybrid contract is a conventional convertible debt instrument in which the holder may only realize the value of the conversion option by exercising the option and receiving the entire proceeds in a fixed number of shares or the equivalent amount of cash (at the discretion of the issuer).** ...*



# *Embedded Conversion Options*

## *Evaluating SFAS 133, 11a scope exception*

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### ❖ EITF 00-19 “Conventional Convertible”

#### Assumptions:

- ◆ \$1,000 convertible debt
- ◆ Convertible at any time at holder’s option
- ◆ Convertible into common stock
- ◆ Conversion price \$10 per share

#### Analysis:

- ◆ Entire proceeds received in shares
- ◆ Number of shares fixed at 100

#### Conclusion: “Conventional”



# *Embedded Conversion Options*

## *EITF 00-19 – “Conventional Convertible”*

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### **Example 1 - Conv. Price Reset Features**

#### **❖ Financial Statement Disclosure**

- ◆ \$1,000 convertible debt
- ◆ Convertible at any time at holder's option
- ◆ Convertible into common stock
- ◆ Conversion price = \$3

#### **❖ Undisclosed Feature**

- ◆ If equity sale at less than \$3 per share, conversion price resets to price in qualifying equity sale



# *Embedded Conversion Options*

## *EITF 00-19 – “Conventional Convertible”*

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### **Example 1- Reset Features (continued)**

#### **EITF 00-19, paragraph 4:**

- ❖ *Conventional Convertible Debt Instrument* is a hybrid contract in which the holder may only realize the value of the conversion option by exercising the option and receiving the entire proceeds in a fixed number of shares or the equivalent amount of cash (at the discretion of the issuer).



# *Embedded Conversion Options*

## *EITF 00-19 – “Conventional Convertible”*

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### **Example 1 - Reset Features (continued)**

#### ***Analysis***

- ❖ “at the discretion of the issuer” = ability to choose form of settlement
- ❖ Reset required settlement in shares
- ❖ NOT Fixed as Number of Shares Dependent on Contingent Future Event (Equity Sale)

***Conclusion – NOT “Conventional”***



# *Embedded Conversion Options*

## *EITF 00-19 – “Conventional Convertible”*

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### **Other Conversion Price Reset Features**

- ❖ **Reset triggered by events within issuer’s control**
  - ◆ **Reset for Subsequent Equity Sale with Floor** - *Reset to subsequent equity sale price if less than conversion price, but in no event will conversion price be less than \$2*
- ❖ **Reset triggered by events outside issuer’s control**
  - ◆ **Reset for failure to register** – *Conversion price reduced by 33% if failure to register by xx/xx/2005*
  - ◆ **Reset for failure to remain listed on NASDAQ**
  - ◆ **Reset for failure to maintain effectiveness**

**Result** – NOT “Conventional” as number of shares dependent on contingent future event (not fixed)



# *Embedded Conversion Options*

## *EITF 00-19 – “Conventional Convertible”*

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### ***“Fixed Number of Shares” is NOT Dependent on Ability to Exercise***

EITF 00-19, paragraph 4:

- ❖ ***Conventional Convertible Debt Instrument is a hybrid contract in which the holder may only realize the value of the conversion option by exercising the option and receiving the entire proceeds in a fixed number of shares or the equivalent amount of cash (at the discretion of the issuer).***



# *Embedded Conversion Options*

## *EITF 00-19 – “Conventional Convertible”*

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### ***Example 2a - “Fixed Number of Shares” is NOT Dependent on Ability to Exercise***

#### **Assumptions:**

- ◆ \$1,000 convertible debt
- ◆ Convertible at holder’s option
  - ◆ After 1 year from issuance
  - ◆ After a secondary offering
- ◆ Convertible into common stock
- ◆ Conversion price \$10 per share

#### **Conclusion:**

- ◆ “Conventional”





# *Embedded Conversion Options*

## *EITF 00-19 – “Conventional Convertible”*

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### ***Example 2b - “Fixed Number of Shares” is NOT Dependent on Ability to Exercise***

#### **Assumptions:**

- ◆ \$1,000 convertible debt
- ◆ Convertible at holder’s option
  - ◆ After 1 year from issuance
  - ◆ After a secondary offering
- ◆ Convertible into common stock
- ◆ Conversion price 80% of avg. trading price

#### **Conclusion:**

- ◆ NOT “Conventional”



# *Embedded Conversion Options*

## *EITF 00-19 – “Conventional Convertible”*

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### *Example 3 - “Entire Proceeds”*

#### **EITF 00-19, paragraph 4:**

- ❖ *Conventional Convertible Debt Instrument is a hybrid contract in which the holder may only realize the value of the conversion option by exercising the option and receiving the **entire proceeds in a fixed number of shares or the equivalent amount of cash** (at the discretion of the issuer).*



# *Embedded Conversion Options*

## *EITF 00-19 – “Conventional Convertible”*

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### **Example 3 - “Entire Proceeds”**

**Assumptions:**

- ◆ **\$1,000 convertible debt**
- ◆ **Convertible at holder’s option into c/s**
- ◆ **Conversion value = (FV of c/s on conversion date less conversion price) multiplied by number of shares received upon conversion**
- ◆ **Conversion price = \$5 per share, but**
  - ◆ **pay cash = to face amount of debt and**
  - ◆ **then cash or shares for difference**  
**between cash paid and conversion value**

**Conclusion: NOT “Conventional”**



# *Embedded Conversion Options*

## *EITF 00-19 – Other Guidance*

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### ***EITF 00-19, paragraphs 12 to 32***

- ❖ Is it **POSSIBLE** that the conversion option would be settled for cash?
  - ◆ Yes - Classify as a liability
    - Does not meet the SFAS 133, paragraph 11a scope exception
    - Measure at fair value each reporting period
  - ◆ No – Classify as equity
    - Meets the SFAS 133, paragraph 11a scope exception
    - Do not separate from convertible instrument
    - Apply EITFs 98-5 and 00-27



# *Embedded Conversion Options*

## *EITF 00-19 – Other Guidance*

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### ***Registration Rights Agreement***

- ❖ **Best efforts to register shares underlying conversion option by certain date**
- ❖ **Often requirement to maintain effectiveness of registration statement**
- ❖ **Liquidating damages if above provisions are not met**



# *Embedded Conversion Options*

## *EITF 00-19 – Other Guidance*

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### ***EITF 05-4: The Effect of a Liquidating Damages Clause on a Freestanding Financial Instrument Subject to EITF 00-19***

#### **4 Views**

- 1. Reg. Right = separate SFAS 133 derivative liability***

***Combine Reg. Right with conversion option.***

***Combined unit is a SFAS 133 derivative liability as:***

- 2. Combined unit not indexed to own stock***
- 3. Combined unit requires partial cash settlement***

***OR***

- 4. Combined unit is SFAS 133 derivative liability only if maximum penalty (Liq. Damages) exceeds difference between fair value of registered and unregistered share.***



# *Embedded Conversion Options*

## *EITF 00-19 – Other Guidance*

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### ***Example 1 – Net Cash Settlement***

***... then upon written demand made by the Holder, the Company will pay to the Holder, in lieu of delivering Common Stock, a sum equal to the closing price of the Company's Common Stock on the principal market or exchange upon which the Common Stock is listed for trading on the trading date immediately preceding the date notice is given by the Holder, less the Purchase Price, for each share of Common Stock designated in such notice from the Holder.***



# *Embedded Conversion Options*

## *EITF 00-19 – Other Guidance*

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### ***Example 2 – No Cap/Limit on Damages = Uneconomic Settlement Alternative***

***... the Company shall, for each such day, pay the Purchaser, as liquidated damages (“Liquidated Damages”) and not as a penalty, an amount equal to twenty-five percent (25%) of the Purchase Price per annum.***





# *Embedded Conversion Options*

## *EITF 00-19 – Other Guidance*

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### *Example 2 - continued*

#### **Two Economic Choices:**

- 1. Deliver Unregistered Shares and Pay Liquidating Damages Equal to 25% per year OR**
- 2. Deliver Registered Shares**



# *Embedded Conversion Options*

## *EITF 00-19 – Other Guidance*

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### *Example 2 – continued*

#### *Economic Decision:*

- ❖ **Are Liquidating Damages Limited to the Difference between the Fair Value of a Registered Share and an Unregistered Share?**
  - ◆ **Yes - Deliver unregistered shares and pay damages because:**
    1. **Fair value of unregistered shares plus damages is not greater than fair value of registered shares**
    2. **Ability to register shares is not within issuer's control**
  - ◆ **No – Deliver registered shares**



# *Embedded Conversion Options*

## *EITF 00-19 – Other Guidance*

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### *Example 2 – continued*

#### *Analysis*

- *Liquidating Damages Accrue at 25% per year*
- *Liquidating Damages are NOT Explicitly Limited*

#### *Conclusions*

- *Damages Can Exceed Difference Between Fair Value of Registered and Unregistered shares*
- *Therefore Unregistered Shares is Uneconomic*
- *Ability to Register Shares is NOT within Issuer's Control*
- *Assume Net Cash Settlement Even If No Net Cash Settlement Provision*



# *Embedded Conversion Options*

## *EITF 00-19 – Other Guidance*

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### *Example 2 – continued*

#### *Results*

- *Classify as a Liability under EITF 00-19*
- *Fails SFAS 133, Paragraph 11a Scope Exception*
- *Separate Embedded Derivative From Convertible Instrument and Account for It at Fair Value*



# *Embedded Conversion Options*

## *EITF 00-19 – Other Guidance*

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### ***Example 3 – No Cap/Limit on Number of Shares to be Issued Upon Exercise***

***EITF 00-19 requires:***

**Sufficient Authorized and Unissued Shares to Settle the Conversion Option Considering All Other Commitments That May Require the Issuance of Stock During the Maximum Period the Derivative Contract could Remain Outstanding**



# *Embedded Conversion Options*

## *EITF 00-19 – Other Guidance*

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### **Sufficient Authorized and Unissued Shares**

- ❖ ***Determine the Maximum Number of Shares that May Need to be Issued for Both***
  - ◆ ***Instrument Being Analyzed and***
  - ◆ ***“All Other Commitments”***
    - ***Includes Employee Options and Other Embedded and Freestanding Instruments***



# *Embedded Conversion Options*

## *EITF 00-19 – Other Guidance*

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### **Sufficient Authorized and Unissued Shares**

- ❖ ***Lack of Cap or Limit in One Instrument May Cause Inability to Determine Maximum Number of Shares***
  - ◆ ***Result***
    - ***Cannot Conclude Sufficient Authorized and Issued Shares Exist***
    - ***Model Assumes Possibility of Net Cash Settlement***
    - ***Classify as Liability***
    - ***Fails SFAS 133 scope exception***
    - ***Fair Value Accounting***



# *Embedded Conversion Options*

## *EITF 00-19 – Other Guidance*

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***Example 3 – No Cap/Limit on Number of Shares to be issued upon exercise may taint all 00-19 contracts***

### **Assumptions:**

- ❖ \$20 million convertible debt
- ❖ Convertible at any time
- ❖ Conversion price is lower of \$5 per share or 80% of daily avg. trading volume of c/s

### **Some Possible Outcomes upon Conversion:**

If conv. price is \_\_\_\_ then issue \_\_\_\_ shares

- ❖ \$5 per share = 4 million shares
- ❖ \$1 per share = 20 million shares
- ❖ \$0.01 per share = 2 billion shares





# *Embedded Conversion Options*

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## *How You Can Help:*

- ❖ Review (Again) Terms in Indenture/Certificate and Related Agreements
- ❖ Identify and Disclose All Embedded Derivative Features
  - ◆ Conversion Option Reset Features
  - ◆ Other Embedded Derivatives
    - Redemption Features at Amounts in Excess of Par (e.g. 200% of par)
    - Interest Rate Floors that Double Rate of Return
  - ◆ Freestanding Warrants
- ❖ Consider POSSIBILITY to Net Cash Settle (Liquidating Damages)
- ❖ Explicitly State in Disclosure Why/Why Not Fair Value Accounting



# *Conclusion*

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## Questions

