



SEC CF 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 2011. Participants were auditors from smaller registered public accounting firms. The slides are intended to provide a sampling of issues that the Staff of the Division of Corporation Finance (“CF” or the “Division”) frequently encounters when reviewing filings for smaller public companies as well as an overview of developments within the Division. 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 notes that provide additional context.



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Agenda

- ❖ **Overview of the Division of Corporation Finance**
- ❖ **Recent Developments**
- ❖ **The Comment Letter Process**
- ❖ **Frequent CF Staff Comment Areas**
- ❖ **Resources**



***Overview of the
Division of Corporation Finance***

Overview of the Division of Corporation Finance

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 on SEC rules and forms**
- ❖ **Recommend new and revised rules to the Commission**

Organization

- ❖ **Disclosure Operations (12 industry groups)**
- ❖ **Legal and Regulatory Policy**
- ❖ **Office of Chief Accountant**
- ❖ **Policy and Capital Markets**

The Division assists the Securities and Exchange Commission (the “Commission”) in executing its responsibility to oversee corporate disclosures to the investing public. Companies are required to comply with regulations pertaining to disclosure that must be made when securities are publicly sold and then on a continuing and periodic basis. The Division Staff reviews the disclosure documents and provides companies with assistance interpreting the Commission's rules and recommends to the Commission new or revised rules for adoption.

The Division 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 investment decisions. Through the Division's review process, the staff checks to see if publicly-held companies are meeting their disclosure requirements in an effort to improve the quality of the disclosure.

The Division provides administrative interpretations of the Securities Act of 1933, the Securities Exchange Act of 1934, and the Trust Indenture Act of 1939, and related rules and regulations. The Staff provides guidance interpretative 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. The Division may communicate its guidance orally, or the Division uses no-action letters and interpretive letters to provide guidance on the regulations in a more formal manner.



Recent Developments

Key SEC Developments

Commission Actions

- ❖ ***Dodd-Frank Act Rulemaking and Studies***

- ❖ ***Commission Statement in Support of Convergence and Global Accounting Standards***
 - ***Work Plan***

- ❖ ***Short-Term Borrowings Proposed Rule and Interpretive Release***

Additional information about the Commission's implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act can be found at <http://www.sec.gov/spotlight/dodd-frank.shtml>.

Additional information about the Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers and related Commission actions can be found at <http://www.sec.gov/spotlight/globalaccountingstandards.shtml>. This includes the Staff Papers: *A Comparison of U.S. GAAP and IFRS* and *An Analysis of IFRS in Practice*, both issued November 16, 2011. They can be found at <http://www.sec.gov/spotlight/globalaccountingstandards/ifrs-work-plan-paper-111611-gaap.pdf> and <http://www.sec.gov/spotlight/globalaccountingstandards/ifrs-work-plan-paper-111611-practice.pdf>, respectively.

Additional information about the Commission's proposed rule on short-term borrowings disclosures and related interpretive release can be found at <http://www.sec.gov/rules/proposed/2010/33-9143.pdf> and <http://www.sec.gov/rules/interp/2010/33-9144.pdf>, respectively.

Key SEC Developments

CF Staff Initiatives

- ❖ **Division of Corporation Finance Financial Reporting Manual Updates**
- ❖ **Corporation Finance Compliance and Disclosure Interpretations**
- ❖ **Dear CFO Letters**
- ❖ **CF Disclosure Guidance Topics**

The Division of Corporation Finance Financial Reporting Manual can be found at <http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.shtml>. The summary of updates can be found at <http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.pdf#changes>.

The Corporation Finance Compliance and Disclosure Interpretations can be found at <http://www.sec.gov/divisions/corpfin/cfguidance.shtml>.

Dear CFO Letters and CF Disclosure Guidance Topics can be found at <http://www.sec.gov/divisions/corpfin/cfdisclosure.shtml#cfguidancetopics>.



The CF Staff Review Process

Filings Subject to CF Staff Review

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

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. To preserve the integrity of the selective review process, the Division does not publicly disclose its review criteria.

In addition, the CF Staff generally 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.

This Division continues to exceed the Sarbanes-Oxley review mandate. CF Staff conducted over 5,000 company reviews last year.

The Division recalibrated the review program to become as efficient and effective as possible, especially with regard to smaller companies. As part of this recalibration, the Division will no longer have specific types of reviews, such as limited or targeted reviews and full reviews – going forward the Division will have reviews and will focus attention wherever needed.

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**

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. Make sure you understand the type of response we are looking for. We usually issue three types of comments:

Request for additional information;

Provide additional or clarifying disclosure in a future filings; or

Amend the filing to revise financial statements or disclosure.

If you don't understand which type of comment you were issued, give us a call.

A company is generally expected to respond in writing to each comment in a letter from 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, it may be necessary to amend a previously filed report or other filings as the result of comments.

Best Practices for Resolving Issues

- ❖ **Prepare a thorough response**
 - **Do not assume CF staff disagrees with accounting treatment**
 - **Key response to initial comment**
 - **Tell us where revised disclosure is located in your response letter**
 - **Discuss supporting authoritative literature in detail**
- ❖ **Inform Staff if you are unable to respond by the requested date**
- ❖ **Call the Staff if you do not understand a comment or need further clarification**
- ❖ **Document accounting decisions contemporaneously**
- ❖ **Furnish all correspondence with the Staff on EDGAR**

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 in question. If you amended your filing, please tell us where the revised disclosure is located in the filing in your response letter. If you are asked to revise your disclosure in future filings, in some situations, we may request an understanding of how you plan to revise your disclosure to satisfy our comment. 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 specific literature in GAAP that it relied upon to reach its conclusions. 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 scope of the issue. All of this can minimize the number of comments and comment letters issued.

Our comment letters request that you respond to the letter within ten business days. If you are unable to respond within this timeframe, please call us to discuss a potential extension. In some circumstances we may ask to have the extension request in writing and submitted to EDGAR.

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. Going through this process at the time of the transaction will allow you to respond more efficiently and effectively to CF Staff comments.

All correspondence must be filed on Edgar. If you don't want certain parts of your response to be released, consider discussing with your legal counsel how to request confidential treatment of a portion of your response under Rule 83. Companies are allowed to request that certain information receive confidential treatment, but you can't request that too much or all of your response be provided to us confidentially. Check our website, which includes helpful information about requesting confidential treatment.



Frequent CF Staff Comment Areas

Frequent CF Staff Comment Areas

- ❖ **MD&A Disclosure**
- ❖ **Reverse Mergers & “Back Door” Registrations**
- ❖ **Business Combinations**
- ❖ **Predecessor Financial Statements**
- ❖ **Equity Transactions**
- ❖ **Embedded Conversion Options and Freestanding Warrants**
- ❖ **Disclosure Controls and Procedures**
- ❖ **Internal Control over Financial Reporting**
- ❖ **Form 8-K**
- ❖ **Other**

Management's Discussion & Analysis (MD&A)

Release Nos. 33-6835 and 33-8350

Results of Operations

- ❖ **What has happened during the period and why?**
 - **Underlying drivers for changes in operating results**

Liquidity

- ❖ **Sources and uses of cash**
 - **What are our bills and how will we pay them?**
 - **Prospective sources of and need for capital**
- ❖ **Going concern matters**

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. The CF Staff often finds that registrants do not adequately discuss the factors contributing to fluctuations in operating results from period to period beyond what is readily apparent from the face of the financial statements. The discussion of fluctuations should help readers understand the operational factors that contributed to changes in underlying line items and the magnitude of their impact.

The liquidity discussion of a registrant's sources and uses of cash may be an area where disclosure is rapidly evolving for a smaller growing company. In providing a discussion of liquidity, the registrant should discuss how it funds its operations by considering what its significant expenses are and how it pays those expenses. In addition, to the extent the registrant will need additional capital in the future – for example, in order to grow through acquisition or fund operations – the registrant should consider providing a clear discussion of the source of that capital and the consequences if it is unable to obtain capital, including a discussion of any going concern considerations.

MD&A requires registrants to disclose known uncertainties that the registrant reasonably expects will have a material impact on income from continuing operations. Using goodwill as an illustration, 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, disclosure 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 CF 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 not previously addressed in disclosure.

Note that the FASB issued Accounting Standards Update No. 2011-08, *Intangibles—Goodwill and Other (Topic 350): Testing Goodwill for Impairment*, in Sept. 2011. The Update simplifies how an entity tests goodwill for impairment and is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption is permitted.

Reverse Mergers & “Back Door” Registrations

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**
 - **Staff 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 company. 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 problematic in the review process because at the time the CF Staff reviews these transactions, the Form 8-K has already been filed and the transaction has been 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.

In certain circumstances, the due date or filing date of the Form 8-K, whichever is earlier, occurs after the end of the private operating company’s most recently completed annual or quarterly period, but before financial statements for that annual or quarterly period would be required to be presented in a Form 10. In these circumstances the financial statements of the private operating company required by Items 2.01(f) and 9.01 of Form 8-K may not include the private company’s most recently completed annual or quarterly period. The public shell company, however, remains subject to Exchange Act Rules 13a-1 and 13a-13, or 15d-1 and 15d-13, requiring annual and quarterly reports, respectively. The public shell company must file its applicable annual and quarterly reports. Additionally, the public shell company must file an amended Form 8-K with the financial statements of the private operating company’s most recently completed annual or quarterly period prior to the date of the reverse recapitalization, as applicable, within 90 or 45 days, respectively, after the private operating company’s period end.

While the historical financial reporting for pre-transaction periods may change to that of the private operating company once the transaction has occurred, the registrant has not changed in this transaction, it is still the public shell company, and therefore is not a newly public company for purposes of SOX 404. However, CF Staff has issued a CDI to provide guidance to companies that 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 registrant excludes management’s assessment of Internal Controls over Financial Reporting (“ICFR”) in the Form 10-K covering the fiscal year in which the transaction was consummated. However, this CDI would not apply if the company had to file an amended Form 8-K under the Rule 13a-1 interpretation discussed above.

Illustration of CF Staff Interpretation of Rule 13a-1

- ❖ **Reverse Merger occurs on February 1, 2012**
- ❖ **Shell (accounting acquiree) and nonpublic operating company (accounting acquirer) have calendar year-ends**
- ❖ **Audited f/s of the private op co for the y/e 12/31/10 and the unaudited f/s for the interim period ended 9/30/10 and comparable prior period would be filed on Form 8-K**
- ❖ **Registrant would file its annual report on Form 10-K for the y/e 12/31/11 within 90 days after 12/31/11**
- ❖ **Registrant would file the same info required in a Form 10-K of the private op co in an amended Form 8-K by the same Form 10-K due date – 90 days after 12/31/11.**
- ❖ **See FRM Section 12220.1**

This slide provides an example of the reporting under the CF Staff Interpretation of Rule 13a-1 discussed on the prior slide.

In SEC Release No. 33-8587, the SEC determined that investors in operating businesses newly merged with shell companies should obtain the same level of information as provided for reporting companies that did not originate as shell companies. Therefore, they are required to include equivalent information as if they were registering under the Exchange Act. Accordingly, the CF Staff looks to the accounting acquirer's eligibility as a smaller reporting company at the time of the reverse acquisition for purposes of the disclosures to be provided in the Form 8-K.

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

Under current accounting literature, the acquisition of a private operating company by a non-operating public shell company 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 operating company for the net monetary assets of the public shell company accompanied by a recapitalization. In order to reflect the change in capitalization, earnings per share should be recast for all historical periods to reflect the exchange ratio. The common stock account of the public shell continues post-merger, while the retained earnings of the shell company should be eliminated as the historical operations are deemed to be those of the private operating company.

Where the registrant is a public shell company requiring the Form 10-level disclosure in the Form 8-K, the private operating company’s financial statements must be audited by a PCAOB-registered firm and audited in accordance with PCAOB standards.

Reverse Mergers & “Back Door” Registrations

Recapitalization Example

- ❖ The transaction was consummated 4/1/09
- ❖ Shell has 100,000 shares o/s @ 3/31/09 (\$1 par)
- ❖ OpCo has 100,000 shares o/s @ 3/31/09 (\$2 par)
- ❖ Shell issues 400,000 shares for 100% of OpCo
- ❖ Post-recap entity has no other equity transactions from 4/1/09 – 6/30/09
- ❖ Post-recap entity has net income of \$300,000 for the period from 4/1/09 – 6/30/09

Slides 19 through 21 provide a summarized example of reporting for a “back door” registration statement accounted for as a recapitalization. You can refer to slides 44 through 52 for additional details.

Reverse Mergers & “Back Door” Registrations

**OpCo SSE 1/1/08 -
3/31/09**

	Number of Shares	Shares at Par (\$2)	APIC	Retained Earnings (Deficit)	Total
1/1/08	60,000	120,000	600,000	300,000	1,020,000
Shares issued for services 7/1/08	20,000	40,000	110,000		150,000
Net Income				250,000	250,000
12/31/08	80,000	160,000	710,000	550,000	1,420,000
Shares issued for cash 2/1/09	20,000	40,000	190,000		230,000
Net Income				200,000	200,000
3/31/09	<u>100,000</u>	<u>200,000</u>	<u>900,000</u>	<u>750,000</u>	<u>1,850,000</u>

Reverse Mergers & “Back Door” Registrations

Post-Recapitalization Continuing Entity SSE 1/1/08 - 6/30/09

	Number of Shares	Shares at Par (\$1)	APIC	Retained Earnings (Deficit)	Total
1/1/08	240,000	240,000	480,000	300,000	1,020,000
Shares issued for services 7/1/08	80,000	80,000	70,000		150,000
Net Income				250,000	250,000
12/31/08	320,000	320,000	550,000	550,000	1,420,000
Shares issued for cash 2/1/09	80,000	80,000	150,000		230,000
Net Income				200,000	200,000
3/31/09	400,000	400,000	700,000	750,000	1,850,000
Recapitalization 4/1/09	100,000	100,000	25,000		125,000
Net Income				300,000	300,000
6/30/09	500,000	500,000	725,000	1,050,000	2,275,000

Business Combinations

- ❖ ***Determination of Accounting Acquirer***
 - **Consideration of all factors (ASC 805-10-55-11 to 15)**
- ❖ ***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**
- ❖ ***Contingent Consideration***
- ❖ ***Disclosures and Separate Financial Statements***
 - **Business vs. Asset Determinations**
 - **Rule 3-05/8-04 of Regulation S-X**

As noted in FASB ASC Section 805-10-25, the determination of the identity of the accounting acquirer may not always be clear from the terms of the transaction. In determining the identity of the accounting acquirer, the company should consider all the indicators in FASB ASC 805-10-55-11 through 15. As transaction terms and the governance provisions for each company may differ, the analysis will be unique to each company, based upon its individual facts and circumstances. Voting interests (including the impact of in-the-money options) are not determinative. We expect management to fully evaluate the factors, including considering the disparity between the two companies in each of the factors, the rights of the various parties to the transaction and how those rights interact (e.g. rights attributable to management as compared to stockholders as compared to the boards of directors), as well as how the individual factors interact with each other.

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.

Smaller registrants may enter into business combinations with family-owned or other privately-held enterprises that are significant to the registrant. If such transactions include additional consideration to be paid to any of the family members or other selling shareholders based upon future performance of the acquired business, the registrant should evaluate FASB ASC paragraph 805-10-55-25 if any family members or selling shareholders continue to be employed by the registrant. Any consideration that is linked to continued employment subsequent to the transaction is deemed to be compensation rather than additional purchase price, which can significantly impact the financial statements.

Because of the difficulty in obtaining pre-acquisition financial statements of an acquired business months after the transaction is closed, it is important to fully evaluate the Commission's requirements for separate financial statements and pro forma financial information prior to the transaction being consummated. Rule 11-01(d) of Regulation S-X defines a business for determining when separate financial statements are required to be filed with the Commission. The principle in the rule is whether there is sufficient continuity in the revenue generating activity so that pre-acquisition financial statements would be meaningful to investors. It is important to note that this definition of a business may yield different results than the evaluation performed for the purposes of FASB ASC Topic 805.

The application of Rule 3-05 compared to Rule 8-04 generally 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 acquired business. 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. The periods for which such financial statements are to be filed shall be determined using the conditions specified in the definition of significant subsidiary in Rule 1-02(w).

Predecessor Financial Statements

- ❖ **Registrant succeeds to substantially all of the business of another entity**
- ❖ **Registrant's own operations are relatively insignificant**
- ❖ **Common in mergers involving Special-Purpose Acquisition Companies**
- ❖ **Financial Statements consistent with Rules 3-01 and 3-02 of Regulation S-X or Rules 8-02 and 8-03 of Regulation S-X**
- ❖ **In post-transaction Exchange Act reports:**
 - **Predecessor periods should be audited up to acquisition date**
 - **Registrant financial statements may also be required unless there is only nominal income statement activity**
 - **Black-line between registrant and predecessor financial statements**

The assessment of whether predecessor financial statements are required is separate from the identification 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 periods required by Regulation S-X with no lapse in audited periods. In addition, Regulation S-K requires Management's Discussion and Analysis covering the financial statements of the predecessor and successor. The staff accepts the use of pro forma information (not combined financial statements) in addition to this historical information to facilitate the discussion.

The CF Staff will request that registrants include the predecessor's financial statements not only in a registration statement at the time the transaction is consummated, but also in any subsequent periodic reports until the predecessor periods are no longer covered by the periodic report. Those financial statements should be audited up to the acquisition date with no gap in periods. Additionally, the company should consider the need to continue including the pre-transaction financial statements of the registrant unless there is only nominal income statement activity (including financing income and costs and merger costs).

Predecessor Financial Statements

Example

- ❖ Shell company merges with an operating company in a transaction accounted for as a purchase.
- ❖ Transaction date: October 14, 2009
- ❖ Combined company has a calendar year-end
- ❖ Merger Form 8-K requirements:
 - Audited financial statements of the operating company as of December 31, 2008 and December 2007 and for the years ended December 31, 2008, December 31, 2007 and December 31, 2006
 - Unaudited interim financial statements as of and for the six months ended June 30, 2009.
 - December 31, 2006 information not required for SRCs (“Smaller Reporting Companies”)

Predecessor Financial Statements

Example (Cont.)

❖ *Presentation in Form 10-K for the Year Ended December 31, 2009 :*

- Audited financial statements of the combined company as of and for the year ended December 31, 2009, but the statements of operations and cash flows will only include the operating company from October 14, 2009.
- Pre-merger audited statements of operations and cash flows of the operating company for the year ended December 31, 2008 (and 2007 if not an SRC) and the period from January 1, 2009 to October 13, 2009 (i.e., no gap in audited periods). The 2009 stub period must be audited.
- Complete set of notes to the financial statements should be provided for each entity.
- Pre-merger financial statements should be clearly labeled as predecessor financial statements.
- Corresponding Management's Discussion and Analysis

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 management's judgment -- ASC 820-10-35 (FSP SFAS 157-3 and 157-4)**

Disclosure

- ❖ **A description of the significant factors, methods and assumptions used to value stock options, warrants and other equity instruments**
 - **Footnotes**
 - **MD&A (critical accounting estimates)**

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 when a registrant has used a value different from quoted market price to value its equity if it is evident that the stock trades in an active market. GAAP explicitly prohibits the application of blockage discounts. 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 determination of fair value or otherwise may consider whether the fair value of the services and/or goods received 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 in 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 to provide disclosure surrounding how the fair value was determined and whether they used contemporaneous or retrospective valuations.

Note that the FASB issued Accounting Standards Update No. 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs, in May 2011. The amendments are effective during interim and annual periods beginning after December 15, 2011. Early adoption is not permitted.

Embedded Conversion Options and Freestanding Warrants

Scope

- ❖ Applies to all contracts that are indexed to, and potentially settled in a company's own stock (e.g., warrants, many conversion options)

Common Pitfalls

- ❖ Cash settlement provisions
- ❖ Insufficient authorized shares
- ❖ No limit on # of shares to be delivered
- ❖ Incorrect conclusion on whether instrument is indexed to a company's own stock
 - "Ratchet Provisions" -- paragraphs 33 and 34 of FASB ASC 815-40-55 (Example 8 of EITF 07-5)

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.

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 or a freestanding warrant being accounted for as a derivative liability are listed on the slide.

Recently, the CF Staff has seen an increase in issues in which smaller companies may be incorrectly concluding that the instrument is indexed to their own stock. For example, convertible debt or freestanding warrant agreements for smaller companies may include "ratchet provisions" that allow for an adjustment in the conversion price or exercise price if the company issues additional equity instruments at a price different from that of the conversion or exercise price. Companies with such provisions in their agreement should consider the guidance in FASB ASC paragraph 815-40-55.

You can find additional information on slides 53 and 54 later in the presentation.

Embedded Conversion Options and Freestanding Warrants

Valuation Issues

- ❖ **Inappropriate model being used to value certain derivatives**
 - **Black-Scholes may not be appropriate in many situations given complex features and terms of conversion option (e.g., combined embedded derivatives)**

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

In addition to the recognition and presentation issues addressed on the prior slides, the staff may issue comments to understand how freestanding 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.

The staff frequently finds that errors in this area are the result of companies not carefully considering and evaluating the accounting implications of provisions of their agreements.

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 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 requires companies to “disclose the conclusions of the registrant’s principal executive and principal financial officers...regarding the effectiveness of the registrant’s disclosure controls and procedures...” Registrants should be aware that the definition of disclosure controls and procedures is broader than the definition of internal control over financial reporting (internal control over financial reporting is generally subsumed in disclosure controls and procedures) 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 ask the company to support a conclusion that disclosure controls and procedures are effective when internal control over financial reporting is ineffective.

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”)***

SOX Section 302 Certifications should not deviate from specific form and content in Item 601(b)(31)(i) of Regulation S-K

- ❖ ***Include all paragraphs (including paragraph 4(b))***

While there is significant overlap between the definition of disclosure controls and procedures and internal control over financial reporting, the conclusions related to internal control over financial reporting are separate and distinct 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 to amend their filings when it appears they have not completed an assessment, they have not disclosed their conclusion on effectiveness, or they have concluded that internal control over financial reporting is effective when material weaknesses exist.

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 (non-accelerated filers must only disclose the elements relevant for their purposes). 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” highlights two other frameworks that meet 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 that companies should consider when material weakness exists (see SEC Release No. 33-8810)

- ❖ **Nature of the material weakness (i.e., identification of the deficiency)**
- ❖ **Impact of control deficiency on the company's financial reporting and its ICFR**
- ❖ **Disclosures should be detailed and specific for each material weakness identified**

Material changes in ICFR

- ❖ **Changes in circumstances without disclosures of changes in internal controls**
- ❖ **Change in conclusion on effectiveness**
- ❖ **Avoid boilerplate disclosure**

The 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. The CF Staff often sees material weakness 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 weaknesses, it does not consider the impact that the weakness could have on other financial statement line items. Similar questions may also arise through a review of 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.

The disclosures required by Item 308(c) of Regulation S-K pertaining to Changes in Internal Control over Financial Reporting are intended to alert investors to circumstances that may create risk through their effect on registrants' internal control. Since these disclosures are required on a quarterly basis, they are helpful in providing timely information that may speak to the quality of a company's financial reporting in any given period and provide an update from the company's most recent annual evaluation of internal control over financial reporting. The CF Staff may issue comments when there is "boilerplate" disclosure that there have been no material changes in the period in situations when conclusions have changed from one year to the next or other identifiable events exist, such as layoffs, change in an outsourcing arrangement, or changes in accounting policy. If a company's conclusion on effectiveness changes from ineffective to effective the company should consider disclosing the reasons for those changes.

Internal Control over Financial Reporting (ICFR)

ICFR for registrants with substantially all their operations outside U.S.

Evaluating

- ❖ **Background and training of CFO or other person(s) responsible for maintaining books and records and preparing financial statements**
- ❖ **Seek information:**
 - **Specific nature of U.S. GAAP experience**
 - **Specific roles / duties of person with U.S. GAAP experience**
 - **Services performed by a third party CPA or consultants – specific nature, extent**

The number of registrants conducting all, or substantially all, of their operations in foreign countries, continues to increase. These registrants include domestic companies that are required to prepare their financial statements in accordance with U.S. GAAP and foreign private issuers that elect to prepare their financial statements in accordance with U.S. GAAP. In certain situations, we have issued comments to understand how these companies have prepared their financial statements and assessed their internal control over financial reporting. In certain cases, companies have had to amend their filings to disclose the lack of U.S. GAAP knowledge within the company as a material weakness.

Our comments focus on such issues as: the existence and extent of education and ongoing training relating to U.S. GAAP; professional qualifications of members of the accounting staff, such as a U.S. CPA license; and professional experience of members of the accounting staff, either as an auditor or preparer of U.S. GAAP financial statements. If the company uses an outside consultant to assist it, the staff may ask about that relationship and the organization/consultant's qualifications.

Form 8-K – Item 4.01

- ❖ **CDIs and FRM – Regulation S-K Section 111 and 211; Exchange Act Form 8-K, Section 114 and 214; and Section 4530 of the FRM**
- ❖ **Failure to specify whether former accountants resigned, declined to stand for re-election, or were dismissed and the date**
- ❖ **Disclosure of disagreements through termination date**
- ❖ **Exhibit 16 letter**
- ❖ **Reverse mergers**
- ❖ **Accounting firm mergers**

The CDI can be found at: <http://www.sec.gov/divisions/corpfin/guidance/regs-interp.htm> and <http://www.sec.gov/divisions/corpfin/guidance/8-kinterp.htm>.

As they relate to Item 4.01 Form 8-Ks, the CF Staff's comments are generally focused on compliance with the item requirements.

The CF Staff may ask for more information and disclosure about the facts and circumstances surrounding the change in accountants. For example, in situations in which the company has dismissed its independent accountant because it has been involuntarily deregistered by the PCAOB, we believe companies should disclose that fact. See S-K CDI 111.07 (repeated at 8-K CDI 114.01).

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.

Two areas where the CF Staff frequently comments are:

- The CF Staff considers an explanatory paragraph in the audit report describing uncertainty about the company's ability to continue as a going concern to be a report modification as to uncertainty as discussed in Item 304 of Regulation S-K that should be disclosed in the Form 8-K. See S-K CDI 111.05.
- The CF Staff views the "subsequent interim period" since the most recent year-end for the purposes of disclosing disagreements to include the period through the termination date. As a result, the CF Staff has requested that companies revise their disclosure if the entire period is not covered already by the disclosure. See S-K CDI 111.01.

Form 8-K – Item 4.01

Section 4530 of the FRM:

- **Subsequent interim period**
- **No reportable events**
- **Remediation of internal control deficiencies**
- **Material weakness or significant deficiency in ICFR**
- **Going concern**
- **Explanatory paragraph in report on ICFR**
- **Revocation of accountant's PCAOB registration**
- **Time period preceding resignation, declination or dismissal**

We made changes to Section 4530 of the FRM. They can be found at:
<http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.pdf#topic4>.

Form 8-K – 4.02

- ❖ **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, comments will generally be focused on compliance with the item requirements. Companies should provide a description of the facts and circumstances leading to the conclusion of non-reliance, 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. 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 generally allows registrants to disclose reportable items in periodic reports coming due if the event occurs within the four business days before the due date of the periodic report. Notwithstanding the general provision of Form 8-K, the CF Staff expects registrants to always report the conclusion that previously issued financial statements can no longer be relied upon under Item 4.02 on Form 8-K rather than in another periodic report as discussed in Form 8-K CDI 215.01.

Other

❖ **Audit Report Signatures**

❖ **SRC status**

❖ **Contingencies**

We sometimes see audit reports in EDGAR filings that do NOT contain the auditing firm's signature. The staff believes that readers should be able to easily determine the name of the firm that audited a registrant's financial statements and therefore, we will request amendments for any filings that do not comply with the requirements of Regulation S-X, which requires a signature. As a result of Regulation S-T, such signature should be in typed form.

SRC Status

- Public float \leq \$75 million on last business day of Q2
- If public float = \$0, \leq \$50 million audited annual revenues

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. If a company newly qualifies as a smaller reporting company based upon its second quarter public float, it may elect to provide the scaled disclosure in its next quarterly report on Form 10-Q. While the company can provide the scaled disclosure immediately, it is still considered an accelerated filer until the filing of its annual report on Form 10-K at which time it becomes a nonaccelerated filer. 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. However, while this company may still provide scaled disclosure in the Form 10-K, it must report as an accelerated filer for purposes of the Form 10-K deadline and include the attestation report on internal control over financial reporting required by Section 404(b) of the Sarbanes-Oxley Act.

For reasonably possible losses, we expect companies to disclose the amount or a quantified range (or, state that the amount or range of loss is immaterial, if true) or if true, state that neither amount nor range can be estimated. The CF Staff expects, where appropriate, loss contingency disclosures to be updated as additional information becomes available. This could mean recording an accrual for a loss, providing new disclosure about a reasonably possible loss that could not be estimated in prior periods, or providing revised disclosure about the estimate. As companies get closer to resolving a contingency, we would generally expect the company to provide more quantitative information. (ASC 450, formally SFAS 5.)



Resources

Resources

www.sec.gov/divisions/corpfin.shtml

❖ **General**

❖ **Filing Review Process**

❖ **Statutes, Rules, and Forms**

❖ **Compliance & Disclosure Interpretations**

❖ **What's New?**

❖ **Information for Small Businesses -**
www.sec.gov/info/smallbus.shtml

Preparers and their auditors can find various resources on the Commission website at www.sec.gov. Specifically, the home page for the Division of Corporation Finance has the following links which may be helpful:

- *Filing Review Process* --- This document provides a detailed explanation of the CF Staff's review process including some of the information covered earlier in this presentation, in addition to listing important contacts throughout the Division.
- *Statutes, Rules, and Forms* – This link can be used to research certain statutes impacting the Commission, various Commission rules and regulations, and item requirements for various SEC forms.
- *Compliance & Disclosure Interpretations* -- This page includes legal interpretative positions taken by the CF Staff on various rules, regulations, and forms categorized by topic.
- *What's New?* – This link is helpful to stay current to changes and new items being added to the Division webpage on a weekly basis.

Additionally, the Division's Office of Small Business Policy maintains a webpage that provides shortcuts to information for smaller companies relating to offers and sales of securities and on their financial and other reporting obligations when their securities are publicly traded.

Resources

Information for Accountants -

www.sec.gov/divisions/corpfin/cfreportingguidance.shtml

- **Financial Reporting Manual**
- **Staff Accounting Bulletins**
- **Publicly Released CF Staff Comment Letters**
- **SEC Staff Speeches**
 - e.g. “Best Practices for Working with the SEC Staff” -- www.sec.gov/news/speech/2009/spch120609ac-ms.pdf
- **Other Frequently Requested Material**
 - Presentation from last year’s forums
 - Letters to Industry (a/k/a “Dear CFO Letters”)
 - Areas of Frequent Staff Comment —Financial Institutions -- www.sec.gov/news/speech/2009/slides1209slh.pdf
 - CF Disclosure Guidance

In addition to the information presented on the previous slide, preparers and their auditors can also access additional information via a link on both the Commission’s and Division’s respective homepages that have various resources relating to accounting and financial reporting. Specifically, preparers and auditors can access the Division of Corporation Finance Financial Reporting Manual (“FRM”). The FRM contains the CF Staff’s interpretation of financial reporting matters. In addition, this section includes Staff Accounting Bulletins which reflect the Commission staff’s views regarding accounting-related disclosure practices. They represent interpretations and policies followed by the Division and the Commission’s Office of the Chief Accountant (“OCA”) in administering the disclosure requirements of the federal securities laws.

Comment letters issued by the CF Staff to specific registrants and their corresponding responses can be accessed at <http://www.sec.gov/answers/edgarletters.htm>. The SEC publicly releases comment letters and response letters. Beginning January 1, 2012, the CF Staff will release filing review correspondence 20 business days following the completion of the review of the filing.

Selected CF Staff speeches, which is non-authoritative guidance given by staff in the Division and the Office of the Chief Accountant, can also be found on the CF website. In addition to these speeches, smaller issuers and their auditors may find the presentation on “Best Practices for Working with the SEC Staff” and the “Areas of Frequent Staff Comment —Financial Institutions” helpful. The “Dear CFO Letters” are sample letters sent to certain companies to address emerging disclosure issues for consideration in advance of preparing disclosures. The letters are posted to the website with the intent of being useful to a broader population of registrants. This year, the CF Staff also started issuing CF Disclosure Guidance. Topics included: staff observations in the review of Form 8-K’s filed to report reverse mergers; cybersecurity; staff observation in the review of promotional and sales material submitted pursuant to Guide 5 and European Sovereign debt exposure.

Resources

Whom do I contact for assistance and how?

- ❖ **Comment process – Disclosure Operations CF Staff**
 - Names and number will be on comment letter
- ❖ **Staff interpretation or informal question**
 - **Financial Reporting – CF Office of Chief Accountant at (202) 551-3400 or submit request through online form at https://tts.sec.gov/cgi-bin/corp_fin_interpretive**
 - **Small Business Policy – CF Office of Small Business Policy (202) 551-3460**
 - **Interpretive questions - Office of the Chief Counsel at 202-551-3500**
 - **EDGAR question – EDGAR Filer Support at 202-551-8900**

It is helpful to contact the CF Staff if you do not understand comments included in any comment letter to ensure you respond to the CF Staff in a complete manner. Additionally, it may be helpful to contact the CF Staff as it relates to timing or other questions about the comment process. In such cases, registrants and their advisors should contact the CF Staff whose names are included on the letter.

Additionally, the CF Staff is available to assist with general interpretive and other questions regarding the federal securities laws and reporting requirements it helps the Commission to administer. General interpretative questions can be directed to the Office of Chief Counsel. The Division of Corporation Finance Offices of Chief Accountant have CF Staff members available to answer questions relating to accounting matters. The CF Office of Small Business Policy have CF Staff members available to answer questions relating to small business matters. In addition to calling the office directly at the phone numbers listed above, registrants, their advisors and auditors can expedite a response by using the Division's online form at https://tts.sec.gov/cgi-bin/corp_fin_interpretive. Using this form, the registrant or its advisors or auditors can provide detailed information regarding the specific question that will be sent directly to a CF Staff member who can consider the facts and respond to the questions.

Resources

Formal Requests related to financial reporting

- ❖ Pre-filing accommodations/waivers/interpretations of reporting requirements
- ❖ Address to the DCF Chief Accountant
- ❖ Mail or email to dcaoletters@sec.gov
- ❖ Clearly state issue and relief sought
- ❖ Clearly state facts and relate them to analysis of issue
- ❖ Clearly state the basis for relief

Formal consultations on the application of GAAP should be sent to - OCA@sec.gov

- ❖ www.sec.gov/info/accountants/ocasubguidance.htm

For CF Staff positions on specific facts and circumstances, including waivers, accommodations, and interpretations related to specific Commission financial reporting requirements, registrants can submit requests in writing directly to the Chief Accountant of the Division. Such submissions should clearly state the issue and relief sought including an analysis of the specific facts and any basis for relief. In requesting accommodations or waivers, a registrant should also consider any alternate presentation or disclosure that might be meaningful to investors in lieu of what is specifically required by Commission rules. When processing such requests, the CF Staff will try to provide a response (whether in writing or via a conference call seeking additional information) within ten business days.

Registrants or auditors who wish to consult with the OCA on issues related to the application of US GAAP or IFRS, or issues related to auditing concerns, such as independence, can submit requests to OCA@sec.gov following the protocol on the website at www.sec.gov/info/accountants/ocasubguidance.htm.



Questions

Key Telephone Numbers

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

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

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

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



Appendix

Recapitalization Example

- ***The transaction was consummated 4/1/09***
 - Shell has 100,000 shares o/s @ 3/31/09
 - OpCo has 100,000 shares o/s @ 3/31/09
 - Shell issues 400,000 shares for 100% of OpCo
- ***Other Information***
 - Post-recap entity has no other equity transactions from 4/1/09 – 6/30/09
 - Post-recap entity has net income of \$300,000 for the period from 4/1/09 – 6/30/09

Recapitalization Example

Balance Sheets @ 3/31/09	Shell	OpCo
Cash	\$ 200,000	\$ 50,000
Assets Other than Cash	<u> </u>	<u>2,000,000</u>
Total Assets	<u>\$ 200,000</u>	<u>\$ 2,050,000</u>
Liabilities	\$ 75,000	\$ 200,000
Shell Common Stock (\$1 par) 100,000 shares o/s	100,000	
OpCo Common Stock (\$2 par) 100,000 shares o/s		200,000
APIC	125,000	900,000
Retained Earnings (Deficit)	<u>(100,000)</u>	<u>750,000</u>
Total Equity	125,000	1,850,000
Total Liabilities & Equity	<u>\$ 200,000</u>	<u>\$ 2,050,000</u>

Shell SSE 1/1/08 - 3/31/09

Shell SSE 1/1/08 - 3/31/09	Number of Shares	Shares at Par (\$1)	APIC	Retained Earnings (Deficit)	Total
1/1/08	40,000	40,000		(60,000)	(20,000)
Shares issued for services 2/1/08	30,000	30,000	60,000		90,000
Net Loss				(10,000)	(10,000)
12/31/08	70,000	70,000	60,000	(70,000)	60,000
Shares issued for cash 3/1/09	30,000	30,000	65,000		95,000
Net Loss				(30,000)	(30,000)
3/31/09	100,000	100,000	125,000	(100,000)	125,000

OpCo SSE 1/1/08 - 3/31/09

OpCo SSE 1/1/08 - 3/31/09	Number of Shares	Shares at Par (\$2)	APIC	Retained Earnings (Deficit)	Total
1/1/08	60,000	120,000	600,000	300,000	1,020,000
Shares issued for services 7/1/08	20,000	40,000	110,000		150,000
Net Income				250,000	250,000
12/31/08	80,000	160,000	710,000	550,000	1,420,000
Shares issued for cash 2/1/09	20,000	40,000	190,000		230,000
Net Income				200,000	200,000
3/31/09	100,000	200,000	900,000	750,000	1,850,000

Post-Recapitalization Continuing Entity SSE 1/1/08 - 6/30/09

	Number of Shares	Shares at Par (\$1)	APIC	Retained Earnings (Deficit)	Total
1/1/08	240,000	240,000	480,000	300,000	1,020,000
Shares issued for services 7/1/08	80,000	80,000	70,000		150,000
Net Income 12/31/08				250,000	250,000
	320,000	320,000	550,000	550,000	1,420,000
Shares issued for cash 2/1/09	80,000	80,000	150,000		230,000
Net Income 3/31/09				200,000	200,000
	400,000	400,000	700,000	750,000	1,850,000
Recapitalization 4/1/09	100,000	100,000	75,000		125,000
Net Income 6/30/09				300,000	300,000
	<u>500,000</u>	<u>500,000</u>	<u>725,000</u>	<u>1,050,000</u>	<u>2,275,000</u>

Post-Recapitalization Continuing Entity SSE 1/1/08 - 6/30/09 (cont'd)

OpCo received 4 shares for each o/s share: Exchange Ratio of 4:1

A	\$1	Equals par value of Shell
B	80,000	Use 4 for 1 Exchange Ratio. 20,000 shares x 4 = 80,000
C	\$80,000	80,000 shares x \$1 par value = \$80,000
D	\$70,000	\$150,000 from (E) below - \$80,000 from (C) above
E	\$150,000	No change from OpCo pre-recap SSE
F	\$200,000	No change from OpCo pre-recap SSE
G	\$200,000	No change from OpCo pre-recap SSE
H	400,000	Should agree to number of shares issued to OpCo by Shell
I	\$400,000	400,000 shares x \$1 par value = \$400,000
J	\$700,000	\$1,850,000 from (L) below - \$750,000 from (K) below - 400,000 from (I) above
K	\$750,000	No change from OpCo pre-recap SSE
L	\$1,850,000	No change from OpCo pre-recap SSE
M	100,000	Number of o/s shares at Shell pre-recap
N	\$100,000	100,000 shares x \$1 par value = \$100,000
O	\$25,000	\$125,000 from (P) below - \$100,000 from (N) above
P	\$125,000	Net assets of shell pre-recap

Shell & OpCo Historical EPS

Shell Pre-Recap Historical EPS

	12/31/08	03/31/09
Net Loss	\$ (10,000)	\$ (30,000)
EPS	\$ (0.15)	\$ (0.38)
Weighted Average Number of Shares	67,500	80,000

OpCo Pre-Recap Historical EPS

	12/31/08	03/31/09
Net Income	\$ 250,000	\$ 200,000
EPS	\$ 3.57	\$ 2.14
Weighted Average Number of Shares	70,000	93,333

Continuing Entity EPS

	12/31/08	03/31/09	06/30/09
Net Income	\$ 250,000	\$ 200,000	\$ 500,000
EPS	\$ 0.89	\$ 0.54	\$ 1.15
Weighted Average Number of Shares	280,000	373,332	436,667

Continuing Entity EPS (cont'd)

OpCo received 4 shares for each o/s share: Exchange Ratio of 4:1

A	\$250,000	No change from OpCo pre-recap Net Income
B	\$0.89	$\$250,000 / 280,000$ weighted avg. shares = \$0.89
C	280,000	Use 4 for 1 Exchange Ratio. 70,000 OpCo pre-recap weighted avg. shares x 4 = 280,000 weighted avg. shares
D	\$200,000	No change from OpCo pre-recap Net Income
E	\$0.54	$\$200,000 / 373,332$ weighted avg. shares = \$0.54
F	373,332	Use 4 for 1 Exchange Ratio. 93,333 OpCo pre-recap weighted avg. shares x 4 = 373,332 weighted avg. shares
G	\$1.15	$\$500,000 / 436,667 = \1.15
H	436,667	$(320,000 \text{ shares} \times 6/6 = 320,000) + (80,000 \text{ shares} \times 5/6 = 66,667) + (100,000 \text{ shares} \times 3/6 = 50,000) = 436,667$ weighted avg. shares

Embedded Conversion Options and Freestanding Warrants

Analysis

- ❖ *Is the instrument within scope of ASC 480-10-15 (SFAS 150)?*
- ❖ *Analyze under ASC 815 (SFAS 133) – two routes*
 1. **Freestanding**
 - **Analyze whether a derivative under SFAS 133**
 - **Perform ASC 815-40 (EITF 00-19) and ASC 815-40-15 (EITF 07-5) analysis to see if scope exception in ASC 815 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 (ASC 815/SFAS 133)**

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 ASC Topic 480, the instrument should be classified and measured using the related guidance.

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 also evaluate the guidance under Subtopic 815-40 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

- **Perform ASC 815-40 (EITF 00-19) and ASC 815-40-15 (EITF 07-5) analysis to see if scope exception in ASC 815 is met for conversion option**
- **If scope exception is met, no bifurcation required, but consider beneficial conversion feature under ASC 470-20 (EITF 98-5 and 00-27)**
- **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 they 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 underlying security, or “host instrument”. 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 instruments when the hybrid financial instrument, the host instrument, is in the form of an equity security or an equity host contract. Understanding the nature of the host instrument 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 clearly and closely related to an equity host instrument but not C&CR to a debt host instrument).

If the embedded feature is not clearly and closely related to the host instrument (FASB ASC 815-15-25-1a) and the entire hybrid instrument is not accounted for at fair value through earnings (FASB ASC 815-15-25-1b), companies should analyze whether the embedded feature would be considered a derivative if it were a freestanding instrument (FASB ASC 815-15-25-1c). That analysis requires an evaluation of whether the feature has the characteristics of a derivative (FASB ASC 815-10-15-83) and whether any scope exception to derivative accounting would be met (FASB ASC 815-10-15).

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 may be redeemed for cash outside the company’s control in determining the classification and measurement of the host instrument.