

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



**National Conference on Current
SEC & PCAOB Developments
December 12, 2006**



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Corporation Finance

Overview

Financial Reporting and Disclosure Issues



Corporation Finance

OVERVIEW

Craig C. Olinger



Overview

Review Statistics

FYE September 30, 2006

- ❖ **4,485 issuer reviews
(more than 1/3 of issuers)**
- ❖ **630 IPOs; 155 new 34 Act reviews**
- ❖ **26.2 days average time for initial
comments on registration statements**



Overview

Organizational Developments

- **DCAO**
- **AD Offices**

http://www.sec.gov/jobs/jobs_accountants.shtml



Overview

Reporting Issues

- ❖ Revenue recognition
- ❖ Article 11 pro formas versus forecasts
- ❖ Non-GAAP income statements



Financial Reporting and Disclosure

IPO with Merger of Entities under Common Control

- ❖ *Financial Statements*
- ❖ *Accounting Issues*

Leslie A. Overton



IPO with Merger of Entities Under Common Control – F/S

❖ *Form of Combined F/S?*

➤ **Historical financial statements**

▪ **Only if**

1) Merger already occurred, OR

2) Merger will occur by IPO effective date and will be accounted for as a reorganization of entities under common control



IPO with Merger of Entities Under Common Control – F/S

- **Change in reporting entity (SFAS 154 ¶23)**

- **Pro forma financial statements**
 - **Pro forma F/S as of & for all periods presented in the historical F/S**
 - ✓ **As if pooling: Reg. S-X, Rule 11-02(c)(2)(ii)**



IPO with Merger of Entities Under Common Control – F/S

- **General rule – pro forma adjustments only to latest year and interim period**
 - ✓ **Acquisition of minority interest**
 - ✓ **Change in capital structure**
 - ✓ **Other transactions**



IPO with Merger of Entities Under Common Control – F/S

❖ *Which F/S?*

➤ **Who is the Parent?**

- **Entity or individual**
- **Control group (EITF 02-5)**

➤ **Predecessor**

- **Entity first acquired by parent**
- **Full F/S all periods**



IPO with Merger of Entities Under Common Control – F/S

➤ **Combined F/S**

- **Only include combining entities from date(s) common control obtained**
- **Adjust periods included, if different FYEs or not controlled whole period**
- **Eliminate intercompany transactions, items, & profits**



IPO with Merger of Entities Under Common Control – F/S

- **May retroactively conform accounting policies (restate F/S)**
- **Reflect equity interests not held by parent as minority interest – B/S & I/S**
- **Capital structure and EPS of each combining entity on face or in notes, unless merger has already occurred**



IPO with Merger of Entities Under Common Control – F/S

- **EPS retroactively restated all periods for change in capital structure**
 - ✓ **Exception - if significant cash distributions in merger, pro forma EPS only for latest year and interim period**



IPO with Merger of Entities Under Common Control – F/S

- **Pre-acquisition F/S – Reg. S-X, Rule 3-05**
 - **Significance of acquisition**
 - ✓ to combined entity, if merger is reflected in historical combined F/S
 - ✓ to predecessor, if not
 - **SAB 80?**



IPO with Merger of Entities Under Common Control – Accounting

❖ ***Merger (SFAS 141 ¶D11-D18)***

- **Historical basis to extent of common control**
- **Cash distributions**
- **Purchase accounting – minority interests**
 - **If acquired by a parent, subsidiary or *another affiliate* (SFAS 141 ¶14)**



IPO with Merger of Entities Under Common Control – Accounting

- **Unless non-substantive (TB 85-5 Q.2.), or**
- **minority interest does not participate in the exchange**

- **Issuer**
 - **Who's the accounting acquirer of the minority interests?**
 - **Reverse acquisition?**



IPO with Merger of Entities Under Common Control – Accounting

- ❖ ***Valuation of issuer's shares to be exchanged in merger***
 - Acquisition of minority interest and/or compensation expense
 - At what date?
 - Valuation methodology, and by reference to other transactions and valuation evidence



IPO with Merger of Entities Under Common Control – Accounting

❖ *Push-down Accounting*

➤ **10/30/79 AICPA Issues Paper,
EITF D-97, SAB 5J**

- **≥95%, pushdown required**
- **80%≤ and <95%, pushdown optional**
- **As if parent prepared GAAP consolidated F/S, but excluded the parent's net assets, ops & cash flow**



IPO with Merger of Entities Under Common Control – Accounting

- **Apply pushdown in combined F/S?**
 - **Accounting acquirer – parent’s basis pushed-down if $\geq 95\%$ owned**
 - **Other combining entities reflect parent’s basis (EITF 90-5)**
 - **If parent is an individual, then their basis to be pushed down is determined ‘as if’ they had prepared GAAP consolidated F/S**



IPO with Merger of Entities Under Common Control – Accounting

- **What if a combining company is a separate SEC registrant?**
 - **Separate historical F/S reflect any required pushdown ($\geq 95\%$ owned)**
 - **If owned 80% to $< 95\%$ and parent chose not to apply push-down – can they apply pushdown now to the subsidiary's separate F/S?**
 - **Parent control form of ownership?**



IPO with Merger of Entities Under Common Control – Accounting

❖ *Impairment*

- **Combined F/S – pushed-down basis; same as in parent’s consolidated F/S**
- **Long-lived tangible and intangible assets and goodwill (SFAS 142 & 144)**
- **Day 2 impairment after reorganization and acquisition of minority interest?**



Financial Reporting and Disclosure

Item 4.02 8-K Issues

Shell Company Reporting

Louise M. Dorsey



Item 4.02 8-K Issues

Item 4.02 Requirements

- ❖ **Due 4 business days after conclusion reached**
- ❖ **Timing driven by who has authority to make decision**
- ❖ **Disclosures in 8-K, rather than 10-Q or 10-K**
 - ◆ **FAQ 1 of FAQs on Form 8-K dated 11/23/04**
 - ◆ **<http://www.sec.gov/divisions/corpfin/form8kfaq.htm>**



Item 4.02 8-K Issues

Item 4.02 Requirements:

4.02(a)

- ❖ Board, Board Committee or Authorized Officer concludes that previously issued financial statements can no longer be relied upon due to error
- ❖ Disclose:
 - ◆ Date of conclusion of non-reliance
 - ◆ Identify f/ss and years no longer reliable
 - ◆ Brief description of facts underlying conclusion
 - ◆ Whether or not Audit Committee, Board or authorized person discussed matters disclosed in 8-K with company's independent accountant



Item 4.02 8-K Issues

Item 4.02 Requirements:

4.02(b)

- ❖ Independent accountant concludes and advises company to take action to prevent reliance on its previously issued audit or review report
- ❖ Disclose:
 - ◆ Date company was advised or notified
 - ◆ Identification of f/ss that can no longer be relied upon
 - ◆ Brief description of information provided by accountant
 - ◆ Whether or not Audit Committee, Board or authorized person discussed matters disclosed in 8-K with company's independent accountant
- ❖ File accountant's letter as exhibit



Item 4.02 8-K Issues

Disclosure Issues

- ❖ **Must clearly state that f/ss can no longer be relied upon**
- ❖ **Avoid unclear underlying reasons for conclusion f/ss or audit report can no longer be relied upon**
- ❖ **Be as specific as possible**



Item 4.02 8-K Issues

Disclosure Issues

- ❖ If multiple misstatements,
 - ◆ Disclose each error clearly and separately
- ❖ Staff may question adequacy of 8-K disclosures if a later restatement reflects items not disclosed in 8-K

Example

- ❖ Nonreliance relates to one of multiple revenue sources
- ❖ 8-K should specify which revenue source
- ❖ Disclose whether revenues overstated or understated
- ❖ Any reliable range of impact should be disclosed



Item 4.02 8-K Issues

Timing Issues

- ◆ **8-K filed on same date 10-K/10-Q amendment filed**
 - **Restatement unlikely to be completed within 4 days of conclusion regarding nonreliance**
 - **Trigger is nonreliance conclusion, not completion of restatement process**
- ◆ **Amended 10-K/10-Q filed for restatement very shortly after 8-K**
 - **Normally takes more time for a restatement**



Item 4.02 8-K Issues

Item 4.02 Form 8-K not automatically required for every restatement

- ❖ **SAB 99 analysis**
- ❖ **Staff will likely question lack of 4.02 8-K if primary f/ss restated via amended 10-K or 10-Q**
- ❖ **SAB 99 analysis necessary to determine whether to file Item 4.02 Form 8-K**



Item 4.02 8-K Issues

Impact on prior 404 assessment

- ❖ **No Item 4.02 8-K requirement to reassess conclusions in prior 404 report by management**
- ❖ **Disclose in 8-K any material weakness in ICFR or DCP known at time of filing**
 - ◆ **Due to duty to correct any prior misstatement in reports when known – Rule 12b-20**



Shell Company Reporting

Shell company merger with private OpCo

- ❖ Item 2.01 and 5.06 8-K due 4 days after merger
- ❖ Form 10/10SB/20-F content
- ❖ PCAOB opinion required - filing considered like an IPO by OpCo
 - ◆ But registered firm not required for audit
- ❖ Unlike a non-shell reverse merger where acquiree f/ss may be audited under US GAAS



Shell Company Reporting

Post-acquisition periodic reporting in year of consummation

❖ Background

- ◆ If acquisition 8-K due or filed within 45 days of Y/E or Q/E, and**
- ◆ 8-K did not include latest year end or quarter end f/ss for OpCo**
- ◆ Exchange Act Rules 13a-1 and 13a-13 apply**



Shell Company Reporting

Rule 13a-1 Post-Acquisition Reporting Domestic Company

- ❖ **Surviving entity must file info required in an annual report for latest year end of private OpCo**
- ❖ **No certifications required – Just updating nonissuer f/ss to prevent gap in reporting**
- ❖ **NOT a special report**
- ❖ **3 years f/ss (2 years for S-B)**
- ❖ **8-K due within time period for 10-K/10-KSB**
- ❖ **Normal '34 Act reporting after that**



Shell Company Reporting

Rule 13a-1 Post-Acquisition Reporting

Foreign Private Issuer

- ❖ If surviving company files acquisition 20-F within 3 months after Y/E, and
- ❖ Acquisition 20-F did not include latest year-end f/ss for OpCo
- ❖ Must file 20-F/A to include all info required by annual 20-F, including most recent year end
- ❖ 20-F/A due within time period required for annual 20-F (6 months after acquisition 20-F filed)
- ❖ Again, no certifications required
- ❖ Normal '34 Act reporting after that



Shell Company Reporting

Rule 13a-13 Post Acquisition Reporting ***Domestic Company***

- ❖ Surviving entity must file 8-K/A to include info required in a quarterly report
- ❖ Latest quarter and interim period to date with comparative prior year info
- ❖ File 8-K/A to update f/ss within time period for 10-Q/10-QSB (45 days after acquisition 8-K filed for non-accelerated filer)

Foreign Private Issuer

- ❖ Not required to file 10-Qs, so no interim updating needed



Shell Company Reporting

Example:

- ❖ Domestic shell consummates merger on Feb 6, 2006
- ❖ 8-K filed on Feb 10, 2006
- ❖ Shell and OpCo have 12/31 year end
- ❖ 8-K includes f/ss for 3 years ended 12/31/04 and interim periods ended 9/30/05 and 04
- ❖ 13a-1 requires surviving company to file f/ss for most recent FYE within 90 days of Feb 10, 2006
- ❖ 8-K/A would include audited f/ss for 3 years ended 12/31/05 plus all other info required by 10-K



Financial Reporting and Disclosure

Analysis of EITF 00-19 on Registered Offerings

Stephanie L. Hunsaker



EITF 00-19 and Registered Offerings

***EITF 00-19 “Accounting for
Derivative Financial Instruments
Indexed to, and Potentially
Settled in, a Company’s Own
Stock”***



EITF 00-19 and Registered Offerings

Par. 14 – 18 of EITF 00-19

Basic Premise:

Events or actions necessary to deliver registered shares are not controlled by the issuer. If the contract permits net-share or physical settlement only by delivering registered shares, cash settlement is assumed.



Securities Act of 1933

Basic Statutory Requirement

All offers and sales of securities for value must be registered, unless the offer and sale associated with a particular transaction is “exempt”



Securities Act of 1933

- ***Securities Act is “transactional” in nature***
 - ❖ ***applies to offers and sales of securities, not to the securities themselves***

- ***Evaluation of whether the exemption is available and when the exemption is needed must be done for both the offer as well as the sale***



Section 4(2) of the Securities Act

- ❖ **Available for an “offering by an issuer that does not involve a public offering”**

- ❖ **Commonly referred to as the “private placement exemption”**



Section 4(2) Illustration

Example – Offer of “Units”

- Each Unit consists of 1 share and 1 warrant

The issuer is offering:

- ❖ *Shares in the units*
- ❖ *Warrants in the units*
- ❖ *Shares of stock underlying the warrants*



Section 4(2) Illustration

- ***When the sale of shares/warrants takes place, the investment decision for those securities is complete***
 - ❖ **Securities received are “restricted” since they were not issued in a public offering**

- ***Offering of shares underlying the warrants is not complete - will continue for term of warrant, or until exercise of warrant***



Section 4(2) Illustration

- ***Since issuer commenced offering privately – issuer can't file a registration statement for the offering of these shares (underlying the warrants)***

Therefore, exemption must be found

- ❖ **Typically the same exemption used for the offer of the shares/warrants will be available**



Public Offering of Warrants

Assume warrants sold in “public offering”

- ❖ **The warrant must be registered for sale, along with the associated offers and sales of the shares underlying the warrant**

- ***Since offer started “publicly”, issuer will not be later able to use 4(2) exemption***



Instruments / Features Subject to EITF 00-19

- **Warrants** – assuming not within scope of SFAS 150

- **Forward contract** – assuming not within the scope of SFAS 150



Instruments / Features Subject to EITF 00-19

Convertible Debt – embedded conversion option evaluated for bifurcation

- ❖ Assuming not within the scope of SFAS 150 and assuming par. 12 of SFAS 133 criteria for bifurcation are met
- ❖ Analyze whether par. 11(a) of SFAS 133 scope exception is met
- ❖ Need to determine whether conversion option is “conventional” – par. 4 of EITF 00-19 and EITF 05-2



Instruments / Features Subject to EITF 00-19

Convertible P/S - embedded conversion option evaluated for bifurcation

- ❖ **First must determine nature of host instrument – more akin to debt or equity**



Instruments / Features Subject to EITF 00-19

Convertible P/S, cont'd

Analysis of Host – par. 61(I) of SFAS 133

- ◆ **Other factors: redemption provisions, nature of returns (stated or participating, mandatory or discretionary), voting rights, collateral requirements, residual participation, liquidation preference, creditor rights**
- ◆ **Judgment is required**



Instruments / Features Subject to EITF 00-19

Convertible P/S, cont'd

- ❖ If more akin to debt – same analysis as convertible debt
- ❖ If more akin to equity – bifurcation not required – look to other GAAP



EITF 00-19 and Registered Offerings

Illustrations of Par. 14-18 of EITF 00-19

- ***Registered unit offering***
- ***Registered equity security unit***
- ***Registered convertible debt / preferred stock***



EITF 00-19 and Registered Offerings

Registered Unit Offering

- ***Seen frequently in “SPAC” offerings***
- ***Issuer will be obligated to deliver a current prospectus to warrant holders in connection with any exercises***
- ***Further registration requirements stem from the separate investment decision being made at time of exercise***



EITF 00-19 and Registered Offerings

Registered Unit Offering, cont'd

- ***Since obligation to deliver registered shares upon exercise, warrants would not qualify for equity classification***

BUT.....

Carefully evaluate terms of contracts



EITF 00-19 and Registered Offerings

Registered Unit Offering, cont'd

- ***Warrant agreements may indicate warrants are not exercisable unless a current prospectus is available***

- ***If clear language that in no event will registrant have to net cash settle the warrants, staff would not object to equity classification (assuming other criteria are met)***



EITF 00-19 and Registered Offerings

Registered Equity Security Units – consists of debt and a forward purchase contract for common shares

- ***Co. has obligation to deliver registered shares upon settlement of forward contract***
- ***Since no further timely filing or registration requirements, share delivery is in issuer's control (par. 18 of 00-19)***



EITF 00-19 and Registered Offerings

Registered Convertible Debt / Preferred Stock

- ❖ **Would register both the convertible instrument, plus shares underlying the convertible instrument**
- ❖ **Section 3(a)(9) exemption will generally be available**
- ❖ **Would qualify for equity classification under par. 14-18 of EITF 00-19**



Proposed FSP 00-19-b

FSP 00-19-b “Accounting for Registration Payment Arrangements”

- ❖ **Will require any contingent obligation to be accounted for under SFAS 5 and FIN 14**
- ❖ **Separate accounting for the instruments subject to the registration rights agreement (i.e. warrants, convertible instruments, etc)**



Proposed FSP 00-19-b

Until adoption of FSP, continue existing methodology with clear disclosure of accounting policy

Proposed effective date – F/S issued for FY beginning after 12/15/06 (i.e. Q1 2007 for 12/31 FY companies)



Financial Reporting and Disclosure

Materiality Judgments

- **Large Errors**
- **Individual Errors and Netting**
- **Quarters**

Todd E. Hardiman



Materiality Judgments

Parameter Number One

Materiality Judgments Must Consider All Relevant Quantitative and Qualitative Factors

Parameter Number Two

If You Believe You Hear Anything To the Contrary, Refer to Parameter Number One



Large Errors

Can A Large Error Be Immaterial?



Large Errors

Staff Accounting Bulletin No. 99

- ❖ **Context = Small Errors Can Be Material**
- ❖ **Illustrative Qualitative Considerations Relate to Small Errors**

If Small Errors Can Be Material, Can Large Errors Be Immaterial?



Large Errors

- ❖ ***Not Sufficient to Cite Absence of SAB 99 Illustrative Qualitative Considerations (Relate to Small Errors)***
- ❖ ***Why Are Misstated F/S Reliable?***



Large Errors

Example

❖ *Break-Even Years?*

2001 - \$100 million loss

2002 - \$50 million loss

2003 - \$100,000 income

2004 - \$50 million income

2005 - \$100 million income

Assume \$20,000 or 20% error in 2003



Large Errors

Limited Circumstances

❖ *Break-Even Years? – Caution*

- ❖ *Regularly Generate Small Income – Not Break-Even***
- ❖ *Most Recent Year – Hard to Demonstrate***
 - ❖ *Multi-Period Turnaround***
 - ❖ *No Clear Trend in Historical Earnings***

❖ *Already Sold Discontinued Operation?*



Individual Errors and Netting

***Can an Individual Error Be Immaterial
Simply Because of the Existence of an
Offsetting Error of Equal Magnitude?***



Individual Errors and Netting

Example:

Error 1 – Overstates Net Income by 30%

Error 2 – Understates Net Income by 28%

Error 1 and Error 2 Combined – Overstate Net Income by 2%



Individual Errors and Netting

Take Away

- ❖ **Evaluate Error 1 and Error 2 Individually Irrespective of Effect When Combined**
- ❖ **If Error 1 or Error 2 is Material, Restate**
- ❖ **If Individual Error Not Material, Separately Evaluate Combined Error. If Combined Error is Material, Restate**



Quarters

Relative Size of the Error

$$\frac{\text{Error}}{\text{-----}} = \% \\ \text{X}$$

❖ *Annual periods: X = Annual Amounts*

❖ *Quarterly periods: Should X =*

◆ *Annual Amounts?*

OR

◆ *Quarterly Amounts?*



Quarters

Materiality

- ❖ **Not Limited to Quantitative Comparisons**
- ❖ **Must Also Include Qualitative Considerations**



Quarters

APB Opinion 28, paragraph 29

- ❖ **In determining materiality for the purpose of reporting** the cumulative effect of an accounting change or **correction of an error, amounts should be related to the estimated income for the full fiscal year** and also to the effect on the trend of earnings. Changes that are material with respect to an interim period but not material with respect to estimated income for the full fiscal year or to the trend of earnings should be separately disclosed in the interim period.



Quarters

APB Opinion 28, paragraph 25 (in part)

- ❖**Previously issued financial statements must also be restated** for a change in the reporting entity (see paragraphs 34, 25, of APB Opinion No. 20) and **for correction of an error (see paragraphs 36, 37, of APB Opinion No. 20).** **Previously issued interim financial information should be similarly restated. APB Opinion Nos. 9 and 20 specify the required disclosures.**



Quarters



Conclusion

Questions

