



# **SEC Staff Review of Common Financial Reporting Issues Facing Smaller Issuers**

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These slides were presented at the Forums on Auditing in the Small Business Environment hosted by the PCAOB during 2008. Participants were auditors from smaller registered public accounting firms and directors and financial executives of smaller public companies. The slides are intended to provide an overview of issues that the SEC Staff frequently encounters when reviewing filings for smaller public companies.



## *Agenda*

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- ❖ **Overview**
- ❖ **Recent Developments**
- ❖ **The Comment Letter Process**
- ❖ **Financial Reporting Issues Frequently Raised in Comment Letters**
- ❖ **Management's Report on Internal Control over Financial Reporting\***
- ❖ **Resources**

\* Forums held in Chicago and Philadelphia in September and October, respectively included a second day attended only by directors and financial executives of smaller public companies. The slides covering management's report on internal control over financial reporting (slides 38 through 47) were only presented to those participants.



## *Disclaimer*

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



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## *Overview*

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## *Divisions and Offices*

- ❖ Four Divisions
  - ◆ **Corporation Finance**
  - ◆ Enforcement
  - ◆ Investment Management
  - ◆ Trading and Markets
- ❖ Eighteen Offices
  - ◆ Chief Accountant (includes Interactive Disclosure)
  - ◆ Compliance Inspections and Examinations
  - ◆ Economic Analysis
  - ◆ 15 Others

## ***Division of Corporation Finance (DCF)***

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***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.”***

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

### ***Organization***

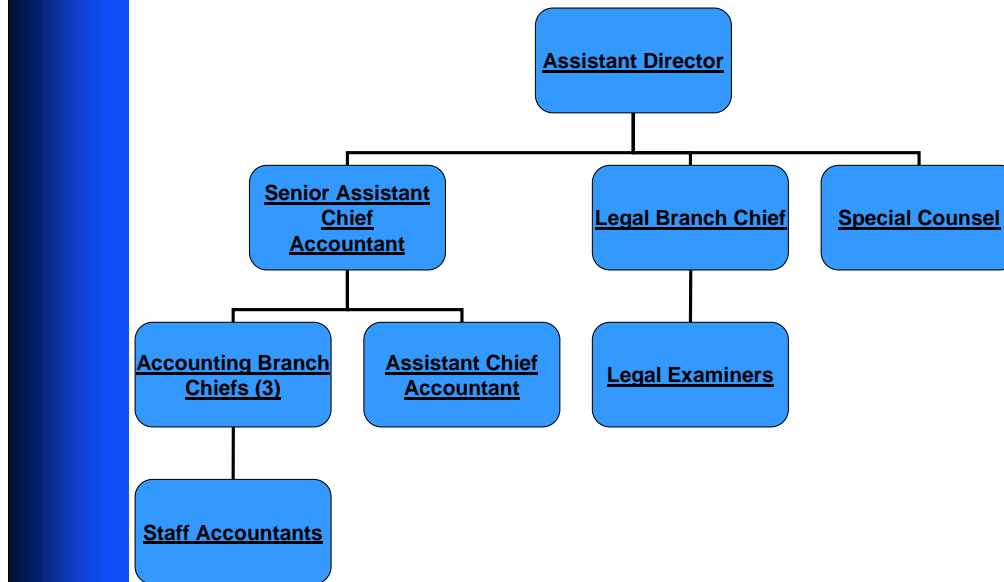
- ◆ **11 industry groups**
- ◆ **Support Offices**

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

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

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

## *Division of Corporation Finance (DCF)*



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

The Division performs its primary review responsibilities through eleven offices staffed with approximately 80 percent of the Division's employees. The members of these eleven offices have specialized industry, accounting, and disclosure expertise. The Division assigns filings by companies in a particular industry to one of the eleven Assistant Director Offices listed. The Division has staffed each office with 25 to 35 professionals, primarily accountants and lawyers. We show each company's office assignment in EDGAR following the basic company information that precedes the company's filing history.

An Associate Director (Paul Belvin, James Daly, or Barry Summer) oversees each Assistant Director Office. The Deputy Director (Shelley Parratt) and Director (John White) oversee the entire filing review process.

## ***DCF – Chief Accountant’s Office***

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### ***Provides technical support to industry groups***

- ❖ **Consultations from the Staff on technical matters**
- ❖ **Registrant’s request for reconsideration of Staff comments**
  - ◆ **May include OCA**

- ❖ **Restatements**

### ***Pre-filing submissions***

- ❖ **Interpretations of reporting requirements**
- ❖ **Waivers/accommodations of reporting requirements**
- ❖ **Interpretations on the application of GAAP (in conjunction with OCA)**

### ***Rulemaking impacting financial reporting***

The Chief Accountant’s Office (“OCA-CF”) within the Division of Corporation Finance is a key support office for Disclosure Operations.

OCA-CF directly supports Disclosure Operations by providing technical support to each of the industry groups. Each of the Associate Chief Accountants (“Associates”) serves at least one Assistant Director Office or Industry Group. The Industry Groups will consult with the Associates on technical accounting and reporting matters identified during the course of a filing review. The Associate will work as a resource with the group to resolve issues that arise through the comment process. OCA-CF may also participate in issues identified through a filing review if the Registrant requests that the Staff reconsider the position taken in the comment process. Finally, OCA-CF will generally review all situations in which the Staff is requesting that a Registrant restate its financial statements to ensure consistency across the Division and thorough consideration. As appropriate, OCA-CF, may request assistance from OCA in any of the above situations.

In addition, OCA-CF interacts directly with Registrants and their advisors on interpretive matters in addition to formal requests for accommodations or waivers. Registrants and their advisors can contact OCA-CF at 202-551-3400 for general interpretative questions or online at [https://tts.sec.gov/cgi-bin/corp\\_fin\\_interpretive](https://tts.sec.gov/cgi-bin/corp_fin_interpretive), but must submit written requests to the Chief Accountant for any formal view on an interpretive matter or waiver related to compliance with a rule. Requests for the staff to consider the registrant’s proposed application of GAAP for a particular issues should be submitted to OCA and OCA-CF will participate (see [www.sec.gov/info/accountants/ocasubguidance.htm](http://www.sec.gov/info/accountants/ocasubguidance.htm)).

OCA-CF also participates in the rulemaking process to the extent it impacts financial reporting. For a clearer description of the rulemaking process, see <http://www.sec.gov/about/whatwedo.shtml#corpfin>.



## *Office of the Chief Accountant*

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- ❖ **Carries out the day-to-day work to assist the Commission in its oversight role over the FASB, which the Commission has designated as a private-sector accounting standard setter**
- ❖ **Also carries out oversight responsibilities related to the PCAOB**
- ❖ **Consults with registrants and auditors regarding the application of accounting, auditing, and independence standards**
  - ◆ [www.sec.gov/info/accountants/ocasubguidance.htm](http://www.sec.gov/info/accountants/ocasubguidance.htm)
- ❖ **OCA and DCF work together closely on:**
  - ◆ **Consultations on certain technical matters relating to the application of GAAP**
  - ◆ **Rulemaking impacting financial reporting**
  - ◆ **Consultations from registrants**
    - **Pre-clearance**
    - **Staff comments**

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

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

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



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## *Recent Developments*

## ***Smaller Reporting Company Relief and Simplification***

***Effective date -- February 4, 2008***

***The reasons for the change are:***

- ❖ **Expand eligibility to use scaled disclosure**
- ❖ **Reduce unnecessary complexity by aligning the categories of “small business issuers” and “non-accelerated filers”**
- ❖ **Simplify disclosure requirements by including scaled disclosure requirements in Regulations S-K and S-X**

***Does not change the level of disclosure required in most cases***

*From the Small Entity Compliance Guide:*

The SEC has adopted a new system of disclosure rules for smaller companies filing periodic reports and registration statements. The new rules are effective February 4, 2008. They are scaled to reflect the characteristics and needs of smaller companies and their investors. They replace the disclosure requirements formerly in the SEC’s Regulation S-B, which applied to “small business issuers.”

The “smaller reporting company” category includes companies that qualified as “small business issuers” before the new rules, as well as most companies that qualify as “non-accelerated filers.” In general, companies that enter the system with less than \$75 million in common equity public float qualify as smaller reporting companies. Companies without a public float typically qualify if they have less than \$50 million in annual revenues upon entering the system.

Under the new system, smaller reporting companies will prepare and file their SEC reports and registration statements using the same forms as other SEC reporting companies, though the information required to be disclosed may differ. Eventually, there will be no special “small business” forms like Forms 10-KSB and SB-2. Instead, smaller reporting companies will use standard forms like Forms 10-K and S-1 used by other companies. Regulation S-X contains the SEC requirements for financial statements, while Regulation S-K contains the non-financial disclosure requirements. To locate the scaled disclosure requirements, smaller reporting companies will refer to the special paragraphs labeled “smaller reporting companies” in Regulation S-K.

## ***Smaller Reporting Company Relief and Simplification***

### **Key Changes**

- ❖ **New Threshold -- \$75 million in public float**
  - ◆ Revenues of \$50 million if public float is zero
- ❖ **“A la Carte” Disclosures**
- ❖ **Financial statement requirements**
  - ◆ Two years of audited balance sheets
  - ◆ Interim filings must contain most recent year-end balance sheet
  - ◆ Rule 3-05 amended to raise threshold at which only two years of financial statements are required from \$25 million in revenues to \$50 million in revenues
- ❖ **Eliminates use of SB forms**

For the most part, the new rules did not change any existing requirements for smaller reporting companies. The only notable changes are as follows:

- Two years of audited balance sheets are now required instead of one.
- Interim filings must contain the balance sheet for the most recent year-end in addition to the interim balance sheet.
- Smaller reporting companies are no longer eligible to prepare a plan of operations under Item 303 of Regulations S-K in lieu of discussing their results of operations.

Smaller reporting companies may choose to comply with scaled or non-scaled financial and non-financial item requirements on an item-by-item basis in any one filing. Where the smaller reporting company requirement is more rigorous, however, the company must meet the more rigorous standard. Currently, the smaller reporting company requirements under Item 404 of Regulation S-K are the only place where the scaled requirements can be more rigorous than the larger company standard.

In addition, *all* registrants that have significant business acquisitions at a level greater than 50% may now exclude the earliest period if the acquired business had revenues less than \$50 million in the most recent year as opposed to \$25 million. This amendment was to be consistent with changes to the definition of a smaller reporting company.

## ***Smaller Reporting Company Relief and Simplification***

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### ***Where can I find more information?***

- ❖ The final rule release --  
<http://www.sec.gov/rules/final/2007/33-8876.pdf>
- ❖ The Small Entity Compliance Guide --  
<http://www.sec.gov/info/smallbus/secg/smrepcosysguid.pdf>
- ❖ Smaller Reporting Company Compliance and Disclosure Interpretations -- <http://www.sec.gov/info/smallbus/src-cdinterps.htm>
- ❖ Division of Corporation Finance Office of Small Business Policy – (202) 551-3460

This slide provides links to the final rule release (no. 33-8876) on the SEC's website. It also provide links to a Compliance Guide written to help smaller reporting companies adopt the new rules and a list of Compliance and Disclosure Interpretations addressed by the Office of Small Business Policy related to the new rule.

## ***Other SEC Key Developments***

- ❖ ***Sarbanes-Oxley***
  - ❖ **Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers (Release 33-8934)**
    - ◆ **Delays Section 404(b) requirement until fiscal years ending after 12/15/09**
  - ❖ **Costs and Benefits Study of Sarbanes-Oxley Act Section 404 (Press Release 2008-8)**
- ❖ ***International Financial Reporting Standards***
- ❖ ***eXtensible Business Reporting Language (XBRL)***
- ❖ ***Committee on Improvements to Financial Reporting recommendations (CIFIr)***

This slide highlights a few other key developments in which the Division of Corporation Finance staff is actively involved. For the latest information on these topics, please visit the following webpages:

*Sarbanes-Oxley Act*

<http://www.sec.gov/spotlight/soxcomp.htm>

*International Financial Reporting Standards (IFRS)*

<http://www.sec.gov/spotlight/ifrsroadmap.htm>

*eXtensible Business Reporting Language (XBRL)*

<http://www.sec.gov/spotlight/xbrl.shtml>

*Committee on Improvement to Financial Reporting (CIFIr)*

<http://www.sec.gov/about/offices/oca/acifr.shtml>

## ***Key US GAAP Developments***

- ❖ **Fair Value Accounting – SFAS 159 and 157**
  - ◆ Effective for fiscal years beginning on or after 11/15/07
  - ◆ Letters on SFAS 157 disclosures –
    - ◆ <http://www.sec.gov/divisions/corpfin/guidance/fairvalue/tr0308.htm> (March 2008)
    - ◆ <http://www.sec.gov/divisions/corpfin/guidance/fairvalue/tr0908.htm> (September 2008)
  - ◆ Clarifications on fair value accounting - <http://www.sec.gov/news/press/2008/2008-234.htm>
  - ◆ FASB Proposed Interpretive Guidance on SFAS 157 – FSP SFAS 157-d
- ❖ **Business Combinations and Noncontrolling interests– SFAS 141(R) and SFAS 160**
  - ◆ Effective for fiscal years beginning on or after 12/15/08
- ❖ **FASB Accounting Standards Codification -- [asc.fasb.org](http://asc.fasb.org)**
  - ◆ One-year Verification Phase
- ❖ **SAB 74 – Requires disclosure regarding impact of new standards**

The FASB has recently been issuing standards that signal a focus on fair value, including two that became effective this calendar year. First, SFAS 159 permits entities to measure certain financial assets and liabilities at fair value. SFAS 157 defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements.

SFAS 141(R) and SFAS 160 will become effective in 2009. SFAS 141(R) has a broader scope than the prior standard and applies to any situation in which an entity obtains control over another. It also changes the recognition for certain assets and liabilities and costs pertaining to the transaction. SFAS 160 will change the accounting for and presentation of non-controlling interests, previously referred to as minority interests.

The FASB launched the one-year verification phase of the *FASB Accounting Standards Codification* (Codification). During the verification period, constituents are encouraged to use the online Codification Research System free of charge to research accounting issues and provide feedback on whether the Codification content accurately reflects existing U.S. generally accepted accounting principles (GAAP) for nongovernmental entities. Users are advised that the Codification content is not yet approved as authoritative and, therefore, they must verify research results using their existing resources for the currently effective literature. It is important to note the Codification was not intended to change US GAAP, but to simplify it by reorganizing all literature in a topical structure.

In light of these developments as well as others not discussed here, we would like to remind registrants of the guidance in SAB 74 which discusses required disclosures to discuss the anticipated impact of new accounting standards that have been issued but not yet adopted.



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## ***The Comment Letter Process***



## ***Comment Letter Process***

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### ***Filings Subject to Staff Review***

- ❖ **Selected by the SEC's confidential internal screening criteria and Sarbanes-Oxley requirements**
- ❖ **IPOs**
- ❖ **Other registration statements**
- ❖ **Annual reports**
- ❖ **Proxy statements**
- ❖ **Item 4.01 and Item 4.02 Form 8-Ks**

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

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

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

## ***Comment Letter Process***

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### ***Types of Comments***

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

### **Levels of Review**

If the Division selects a filing for further review, the extent of that further review will depend on many factors, including the results of the preliminary review. The level of further review may be:

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

### **Staff Comments**

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

## *Comment Letter Process*

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### ***Best Practices for Resolving Issues***

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

A company generally responds to each comment in a letter to the staff and, if appropriate, by amending its filings. A company's explanation or analysis of an issue will often satisfactorily resolve a comment. Depending on the nature of the issue, the staff's concern, and the company's response, the 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 Division and the company resolve the comments.

It is most important for registrants to take the time and prepare a thorough response. The response should be focused on the specific questions asked by the staff, but should be robust so the staff fully understands the accounting and/or disclosure being questioned. If the registrant has revised its filing or plans on revising its filings in response to the staff's comments, it is very helpful to provide proposed disclosure or marked pages. If the staff has asked a question on the registrant's basis for a particular accounting treatments, it is important for them to refer to any literature in GAAP that they relied upon to reach their conclusions.

Again, providing a detailed and complete explanation to the staff in response to the initial comment letter may lessen the likelihood of future comments or at least narrow the dialogue. To ensure your response is sufficient, the ten business days referred to in the comment letter may not be adequate. In case, you should simply contact the staff and discuss the date on which you expect to respond.

Finally, it will 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.



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

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

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- ***Revenue Recognition***
- ***Business Combinations (incl. Reverse Mergers)***
- ***Equity Transactions***
- ***Embedded Conversion Options and Warrants***
- ***Management's Discussion and Analysis***
- ***Forms 8-K on Item 4.01 and Item 4.02***
- ***Internal Controls over Financial Reporting***
- ***Certifications***
- ***Audit Reports***
- ***Other Areas (see Appendix)***

# *Revenue Recognition*

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## **Common Areas of Comment**

- ❖ **Policy disclosures (i.e., SAB 104)**
  - ◆ **“Boilerplate” disclosures**
  - ◆ **Disclosure should be specific to company’s revenue streams**
- ❖ **EITF 00-21 – Multiple-Element Arrangements**
- ❖ **EITF 99-19 – Gross versus Net Revenue Recognition**

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

As it relates to revenue recognition under EITF 00-21, the staff frequently comments in situations where it is not clear that deliverables qualify as separate units of accounting or appears that they do not qualify as separate units. In such situations, the staff may ask the registrant how they evaluated each of the criteria in paragraph 9 to conclude that the delivered item could be considered a separate unit of accounting.

Companies may recognize revenue on a gross basis when the disclosures raise question as to whether registrant is really acting as an agent and should be report revenue on a net basis. The opposite may occur where revenue is presented on a net basis, but the registrant’s business appears to be more in line with a principal. If there is not transparent disclosure in MD&A or elsewhere as to how the registrant reached its conclusions, the staff may comment and ask how the registrant has evaluated each of the indicators in EITF 99-19, and which specific indicators carry the most weight in their fact pattern.

# ***Business Combinations***

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## ***Business combination or asset purchase***

- ❖ EITF 98-3
- ❖ Rule 11-01(d) of Regulation S-X

## ***Purchase Price Allocation***

- ❖ Allocated to all assets and liabilities acquired based upon fair value
- ❖ Fair value of securities issued

## ***Disclosures***

- ❖ Annual vs. Interim periods

*NOTE: This slide presents comments issued by the staff prior to the effectiveness of SFAS 141(R), which is effective for fiscal years beginning on or after December 15, 2008; therefore it does not consider how these issues may be impacted by the revised standard.*

The threshold question when reviewing disclosures related to a business combination is “Is the transaction an acquisition of a business or assets?” Registrants should understand that you can reach different conclusion for accounting and reporting purposes. EITF 98-3 defines a business for determining if the transaction should be accounted for as a business combination under SFAS 141. Rule 11-01(d) of Regulation S-X defines a business for determining what financial information, such as separate financial statements are required to be filed with the SEC.

The staff may also frequently 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 staff may request more information in situations where a disproportionate amount of the purchase price is allocated to goodwill may. This is even more likely if descriptions of the transaction indicate that other intangible assets may have been acquired, but no fair value assigned.

Also, as it relates to intangible assets, the staff may raise questions when companies conclude that acquired intangible assets have indefinite lives, while some of the factors in paragraph 11 of SFAS 142 may be present. The staff may also comment in situations in which a registrant appears to be defaulting to using the straight-line method when there may be clear evidence of another pattern in which the economic benefits of the asset are consumed.

Paragraphs 51 – 57 of SFAS 141 requires disclosures for both annual period, paragraph 58 for interim periods. Registrants should ensure they have included all disclosures addressed in the standard.

# ***Business Combinations***

## ***Reverse Acquisitions/Recapitalizations***

- ❖ **Determination of the accounting acquirer**
  - ◆ **Consider all factors in paragraph 17 of SFAS 141**
- ❖ **Cost of the acquired entity**
  - ◆ **Depends on whether it is a business combination or recapitalization**
- ❖ **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**
- ❖ **Form 8-K requirements**

As in any acquisition, the accounting acquirer in a reverse acquisition is identified by consideration of all the facts and circumstances, including the conditions in paragraph 17 of SFAS 141.

The acquisition of a private operating company by a non-operating public shell is considered to be a capital transaction in substance, rather than a business combination. That is, the transaction is a reverse capitalization, equivalent to the issuance of stock by the private company for the net monetary assets of the shell corporation accompanied by a recapitalization. The accounting is similar to that resulting from a reverse acquisition, except that no goodwill or other intangible assets should be recorded.

In a public shell reverse acquisition, the consideration transferred for the acquisition is recorded at the net book value of the assets of the public shell. However, in a reverse acquisition of a business, the accounting is the opposite of the legal form of the transaction. The cost of the acquired entity equates to the fair value of the outstanding equity interests of the legal acquirer on the acquisition date, excluding the shares issued in the merger.

Stockholders' equity for periods after the reverse acquisition is the equity of the combined entity. Capital stock is stated as the par value of the legal acquirer's outstanding common stock after giving effect to the number of shares issued in the reverse acquisition. Historical stockholders' equity of the accounting acquirer for periods before the acquisition is consummated is retroactively restated to reflect the par value of the legal acquirer's capital stock outstanding at each balance sheet date after giving effect to the number of shares issued in the merger. Any difference between the capital stock of the legal acquirer and the accounting acquirer is recorded as an adjustment to paid-in capital of the combined entity.

Operations prior to the merger are those of the accounting acquirer. Operating results for the legal acquirer are included in the financial statements of the combined entity from the date of acquisition. EPS for periods prior to the merger are restated to reflect the number of equivalent shares received by the accounting acquirer's shareholders, that is, the average number of shares of the accounting acquirer outstanding during each period multiplied by the exchange ratio.



## ***Business Combinations***

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### ***Entities Under Common Control***

- ❖ Net assets of acquiree are recorded at historical basis
- ❖ Determining control group

### ***Separate Financial Statements of an Acquired Business***

- ❖ Rule 3-05/Rule 8-04 of Regulation S-X

### ***Predecessor Financial Statements***

- ❖ Registrant succeeds to substantially all of the business of another entity
- ❖ Registrant's own operations are relatively insignificant

Combinations of entities under common control are not considered business combinations under SFAS 141. The accounting for such transactions is in Appendix D to the standard. In general, such transactions between entities under common control are recorded at historical cost with retrospective presentation to the initial date in which the entities were under common control. The accounting is similar to the prior accounting for pooling transactions under APB 16.

A control group is defined in EITF 02-5. A control group generally is immediate family members or a group of shareholders with contemporaneous written evidence of an agreement to vote in concert.

A combination between entities under common control does not preclude the requirement for separate financial statements or pro forma financial statements (in the case of a probable transaction).

Generally, separate financial statements are required under Rule 3-05 of Regulation S-X for an acquired business or a probable acquisition, in the case of a registration statement. The number of periods required is dependent on the significance tests in Rule 1-02(w).

In certain situations, a business may be deemed as the predecessor of the registrant. The definition of a predecessor is when the registrant succeeds to substantially all of the business of another entity and the registrant's own operations are relatively insignificant. In such cases, the predecessor must include the same periods and information, such as MD&A required for the registrant.

# *Equity Transactions*

## ***Fair Value Determination***

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

## ***Disclosure***

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

When smaller companies incorrectly determine fair value for equity issued to consummate certain transactions, such as compensation arrangements and business combinations, it can often lead to material misstatements. The staff will frequently comment if a registrant has used a value different from quoted market price to value its equity if it is determined that the stock trades in active market. Blockage discounts are not permitted if using quoted market price. Discounts trading restrictions may be permitted 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 staff may look to cash transactions with third parties for the same security in close proximity to support fair value or other may consider the fair value of the services and/or good if that measure is more reliable. Absent market prices in an active market or other objective measures of fair value, management should use its judgment considering the fair value hierarchy in determining a fair value that is supportable

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

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

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### ***Primary issues:***

- ❖ ***Bifurcation of conversion option***
- ❖ ***Classification as liability or equity***

### ***Instruments involved:***

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

***NOTE: Slides on Embedded Conversion Options and Freestanding Warrants present comments issued by the staff in past years and therefore, prior to the effectiveness of certain EITF Issues and FASB Staff Positions. Preparers may need to separately consider how FSP APB14-1, EITF Issues 07-5, 08-4, and 08-8 may impact their conclusions.***

Because of the complexity of the financing transactions as well as the complexity of the underlying accounting guidance, issues pertaining to convertible instruments and warrants have become a source of staff comments and restatements in recent years.

The comments have primarily involved convertible debt instruments, but convertible preferred stock and freestanding warrants have also been impacted.

## ***Embedded Conversion Options and Freestanding Warrants (cont'd)***

### **Analysis**

- ❖ ***Is the instrument within scope of SFAS 150?***
- ❖ ***Analyze under SFAS 133 – two routes***
  1. **Freestanding**
    - **Account for as a derivative under SFAS 133**
    - **Perform 00-19 Analysis in consideration of EITF 01-6**
      - **Account for as equity**
      - **Account for as a liability**
  2. **Embedded**
    - **Do not bifurcate under SFAS 133 (this often requires performing an EITF 00-19/EITF 01-6 Analysis which may require bifurcation)**
    - **Consider ASR 268/EITF D-98 and APB 14**
    - **BCF under EITF 98-5 and 00-27**
    - **Bifurcate – Account as derivative liability (SFAS 133)**

***NOTE: Slides on Embedded Conversion Options and Freestanding Warrants present comments issued by the staff in past years and therefore, prior to the effectiveness of certain EITF Issues and FASB Staff Positions. Preparers may need to separately consider how FSP APB14-1, EITF Issues 07-5, 08-4, and 08-8 may impact their conclusions.***

It is a complicated path to determine the appropriate accounting for such instruments. The first step is to determine whether the instrument is within the scope of SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*. If the instrument is within the scope of SFAS No. 150, the guidance in that standard will determine whether the instrument should be classified as a liability or equity.

If the financial instrument is a freestanding warrant and is not within the scope of SFAS No. 150, it may be within the scope of SFAS No. 133. Presuming the warrant is indexed to a company's own stock under EITF Issue 01-6, companies should evaluate EITF Issue 00-19 to determine whether the instrument is more appropriately classified within equity with no adjustments for changes in fair value or classified as a liability at fair value with adjustments each period.

As it relates to hybrid financial instruments, such as convertible debentures, any embedded derivatives must be analyzed under paragraph 12 of SFAS No. 133 to determine whether the derivative should be bifurcated and accounted for separately under SFAS No. 133. A key component in that analysis is determining whether the embedded derivative is clearly and closely related to the host, which more frequently fails to be the case for convertible debt instruments. Companies should consider the staff's views in EITF Topic D-109 when the hybrid financial instrument is in the form of a share. If it is not clearly and closely related and is indexed to the company's own stock under EITF Issue 01-6, companies should analyze whether the embedded derivative would be classified as a liability or equity under EITF Issue 00-19 if it were a freestanding derivative.

If the embedded derivative is not bifurcated under SFAS No. 133, the company should consider EITF Topic D-98 and ASR 268 if the instrument is redeemable preferred stock in determining the classification and measurement. Finally, companies should consider whether there is a beneficial conversion feature to be accounted for under EITF Issues 98-5 and 00-27. This will generally be the situation when the effective conversion price (after consider any allocation of proceeds to detachable warrants under APB 14) is less than the market value of the company's stock on the commitment date.

## ***Embedded Conversion Options and Freestanding Warrants (cont'd)***

### **Scope of EITF 00-19**

- ❖ Applies to all contracts that are indexed to, and potentially settled in a company's own stock
- ❖ Paragraphs 12 through 32 do not apply to conventional convertible debt instruments

### **Common Pitfalls of EITF 00-19**

- ❖ Cash settlement provisions
- ❖ Required to settle in registered shares
  - ◆ Registration Payment Arrangements are accounted for separately under FSP EITF 00-19-2
- ❖ Insufficient authorized shares
- ❖ No limit on # of shares to be delivered
- ❖ Incorrect conclusion on whether instrument is indexed to a company's own stock (EITF 01-6)

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

***NOTE: Slides on Embedded Conversion Options and Freestanding Warrants present comments issued by the staff in past years and therefore, prior to the effectiveness of certain EITF Issues and FASB Staff Positions. Preparers may need to separately consider how FSP APB14-1, EITF Issues 07-5, 08-4, and 08-8 may impact their conclusions.***

As discussed on the previous slides, EITF Issue 00-19 is instrumental to this analysis. The issue generally applies to freestanding derivatives that are indexed to and potentially settled in a company's own stock. In the situation of evaluating convertible debt instruments, companies must first conclude whether the instrument is a conventional convertible debt instrument, as explained in EITF Issue 05-2. If the instrument is a conventional convertible debt instrument then paragraph 12 through 32 of EITF Issue 00-19 do not apply and will not have to be evaluated, but the remaining paragraphs should still be considered. It is important to note that agreements that contain clauses to adjust the conversion price other than *standard* anti-dilution provisions that apply to *all* shareholders are not considered conventional convertible. This frequently creates problems for smaller companies.

Some other common pitfalls that may lead to an embedded derivative needing to be bifurcated and accounted for as a derivative liability are listed on the slide.

That staff frequently finds that restatements in this area are commonly the result of companies not carefully considering and evaluating the accounting implications of provisions of their agreement at the time they are negotiating them or when the transaction is completed.

# *Management's Discussion & Analysis (MD&A)*

**Release Nos. 33-6835 and 33-8350**

## **Best Practices**

- ❖ **Executive-level overview (including discussion of impact of current economic conditions)**
- ❖ **Critical accounting estimates**
  - ◆ **Provide insight into the quality and variability of financial information (including fair value measurements)**
- ❖ **Comparative results of operations that are thorough and address the causal factors of change**
- ❖ **Liquidity and capital resources**
  - ◆ **Enhanced analysis and explanation of the sources and uses of cash**
    - **Consider categories reported on statement of cash flows**
  - ◆ **Address going concern matters**
  - ◆ **Consider enhanced disclosure regarding debt instruments, guarantees and related covenants.**

The MD&A has three general objectives: to provide a narrative explanation of a company through the eyes of management; to 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, the staff generally recommends that companies provide an overview highlighting BOTH financial and non-financial key performance indicators as background to understanding the company's overall performance for the periods.

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

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

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

## ***Form 8-K***

**Form 8-K interpretations updated on June 26, 2008  
at <http://www.sec.gov/divisions/corpfin/guidance/8-kinterp.htm>**

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

### ***Frequent Item 4.01 comments***

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

As mentioned in a prior slide, Forms 8-K on Items 4.01 and 4.02 are frequently reviewed by the staff.

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

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

## ***Form 8-K***

### ***Most Item 4.02 comments relate to Item 4.02(a)***

- ❖ **Triggering event other than non-reliance conclusion (e.g., completion of restatement)**
- ❖ **Unclear statement regarding non-reliance**
- ❖ **Brief description of facts lacking or unclear**
- ❖ **“Stealth restatements”**

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

Form 8-K allows registrants to disclose reportable items in periodic reports coming due if the event occurs within the four business days. Therefore, certain companies have been disclosing the non-reliance on previously issued financial statements in the same report (either 10-K or 10-Q) in which they are restating their financial statements. The staff has commented in an FAQ document referred to in an earlier slide, that we would expect registrants to always report Items under 4.01 and 4.02 on Form 8-K rather than in another periodic report.



## ***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**
- ❖ **Disclosures when material weakness exists**
  - ◆ **Nature of the material weakness**
  - ◆ **Impact of material weakness on company’s financial reporting and ICFR**
  - ◆ **Current plans, if any, or actions already undertaken to remediate the material weakness (could be included in Item 308 (c) of Regulation S-K)**
  - ◆ **Should be detailed and specific for each material weakness identified**

All issuers, other than newly public companies, registered investment companies, and asset-backed issuers, are required to include management’s report on internal control over financial reporting in their annual reports.

While there is some overlap between disclosure controls and procedures and internal control over financial reporting, management is required to assess the effectiveness of each on an annual basis and only disclosure controls and procedures on a quarterly basis, including year-end.

Registrants are required to disclose all material weaknesses identified. If any material weaknesses are identified, management must conclude that internal controls over financial reporting are ineffective. Disclosures of material weaknesses are most helpful if they allow the reader to determine the pervasiveness and impact on the financial statements. Registrants should also consider specifically explaining the weaknesses in internal controls that were identified rather than limiting the discussion to identifying the impacted financial statement area.

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

## ***Internal Control over Financial Reporting (ICFR)***

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### ***Auditor attestation under Item 308(b) of Regulation S-K***

- ❖ **No specific requirement for location in filing**
  - ◆ Generally in close proximity to financial statement opinion or management's report
- ❖ **Not currently required for non-accelerated filers**
- ❖ **If auditor attestation not included, registrant must include statement that ICFR has not been attested to by auditor (See Item 308T of Regulation S-K)**

The auditor attestation on internal control over financial reporting is currently only required for accelerated filers and large-accelerated filers. The requirement to include the auditor attestation has been deferred for non-accelerated filers until years ending on or after December 15, 2009. Such filers should include the disclosure specifically referred to in Item 308T of Regulation S-K to inform readers why the attestation report has not been included.

## ***CEO/CFO Certifications***

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

### ***Internal control over financial reporting (ICFR)***

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

The certifications required by Section 302 of the Sarbanes-Oxley Act and included as an exhibit to the quarterly reports and annual report cannot deviate in form or content from what is included in Item 601(b)(31)(ii) of Regulation S-K. To the extent necessary, management must include appropriate disclosures in the filing that allow them to sign the certifications as prescribed.

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

## ***Audit Reports***

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

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

In the situation of an initial registration statement, the audit report must refer to PCAOB standards. However, since the company is not considered an “issuer” at that time, their accountant does not need to be registered. They will need to be registered for any opinions on subsequent periods or any additional work on the periods included in the registration (e.g. restatements). Unregistered firms are still able to issue consents for periods audited prior to the initial registration statement.

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

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



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***Management's Report on Internal  
Control over Financial Reporting***



## ***Management's Report on Internal Control over Financial Reporting***

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- ***Current Status (Where are we now?)***
- ***Recent Developments***
- ***Staff observations***
- ***Overview of Management's Assessment***

## ***Current Status (Where are we now?)***

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- ***Provide Management's Assessment Only***

- ❖ **Nonaccelerated Filers**
- ❖ **Years ended after on or after 12/15/07**

- ***Provide BOTH Management's Assessment and Auditor's Attestation***

- ❖ **Accelerated Filers**
- ❖ **Large Accelerated Filers**
- ❖ **All Companies beginning with years ending on or after 12/15/09**

- ***Exceptions***

- ❖ **New Public Companies**
- ❖ **Business Combinations (as it relates to acquired business)**
- ❖ **Other**

Beginning with fiscal years ended on or after December 15, 2007, nonaccelerated filers are required to conduct an evaluation of internal control over financial reporting and furnish an assessment under Section 404(a) of the Sarbanes-Oxley Act of 2002. Accelerated filers (including large accelerated filers) are required to file management's assessment of internal control over financial reporting under Section 404(a) AND an attestation report by its independent registered accountants under Section 404(b) of the Sarbanes-Oxley Act of 2002.

Based upon the most recent rulemaking by the Commission, all issuers will be required to file management's assessment of internal control over financial reporting AND an attestation report by its independent registered accountants for fiscal years ending on or after December 15, 2009. This may be impacted by the cost-benefit study that will be performed at the direction of the Commission. The only exception to the requirement to provide management's assessment of internal control over financial reporting relates to newly public companies, registered investment companies, and asset-backed issuers. Instruction 1 to Item 308 of Regulation S-K limits the requirements to registrants who had been required to file or had filed an annual report with the SEC for the prior year.

Guidance issued by the staff in the form of a Frequently Asked Questions (<http://www.sec.gov/info/accountants/controlfaq.htm>) document permits companies to exclude material acquired businesses accounted for as business combinations from the scope of their assessment for the year in which the transaction was consummated if it is impracticable to assess the controls of the business prior to filing the annual report. In such circumstances, the registrant must disclose the significance of the business to the consolidated financial statements. Neither this guidance nor the release providing relief to newly public companies permits any relief or scope exceptions to reverse mergers or similar transactions. Companies who are unable to conduct an assessment due to the consummation of a transaction not addressed in any Staff guidance or SEC rules (such as reverse mergers) should contact the Staff prior to their year-end.

## *Recent Developments*

- ❖ **404(a): SEC's Guidance for Management**
  - ❖ Interpretive Guidance approved by Commission on May 23, 2007
  - ❖ Issued - *"Sarbanes-Oxley Section 404: A Guide for Small Business"*
  - ❖ Both available on SEC website at:  
<http://www.sec.gov/spotlight/soxcomp.htm>
  
- ❖ **404(b): PCAOB's Guidance for Auditors**
  - ❖ Auditing Standard No. 5 (AS 5)
    - ❖ *Approved by PCAOB on May 24, 2007*
    - ❖ *Approved by Commission on July 25, 2007*
  - ❖ Draft Issued – *"Preliminary Staff Views – Guidance for Auditors of Smaller Public Companies"*

Related to Section 404(a) of the Sarbanes-Oxley Act of 2002, the SEC issued 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 ("Management's Guidance") in May 2007. It is not required to be followed. The release was issued specifically to provide management guidance for one way to complete a top-down risk-based evaluation of internal control over financial reporting. Prior to its issuance, there was no management guidance; therefore, management often used the auditing standards in completing its assessment.

The Staff also issued a brochure or guide for smaller companies completing their assessment of internal control over financial reporting. The brochure provides a brief overview of the approach outlined in Management's Guidance that may assist smaller reporting companies in completing their evaluations. However, it is not a replacement for Management's Guidance.

In conjunction with issuing Management's Guidance, the PCAOB issued Auditing Standard No. 5 ("AS5") which superseded Auditing Standard No. 2 ("AS2"), the prior auditing standard on audits of internal control over financial reporting. The SEC approved AS5 in July 2007 and it is now effective for all audits of internal control over financial reporting. In addition, the PCAOB has issued a draft document on Preliminary Staff Views – Guidance for Auditors of Smaller Public Companies which should be a helpful resource for firms applying AS5 to smaller public companies.



## *Recent Developments*

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- ❖ **404(b): Deferral of Compliance for Non-Accelerated Filers**
  - ❖ Provides additional one-year deferral (years ending on or after 12/15/09)
- ❖ **Cost-Benefit Study**

The SEC has recently deferred the requirement for nonaccelerated filers to comply with 404(b) until fiscal years ending on or after December 15, 2009. As mentioned in the release accompanying the extension, one of the primary drivers for the deferral related to a study that the Commission is undertaking to help determine whether our new management guidance on evaluating ICFR and AS No. 5 are having the intended effect of facilitating more cost-effective ICFR evaluations and audits for smaller reporting companies. This study, which is being led by our Office of Economic Analysis, includes gathering data from a broad array of companies about the costs and benefits of compliance with the ICFR requirements.

## ***Top 5 Deficiencies for First-timers***

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- 1. Companies began but did not finish their assessment***
- 2. Companies were silent as to whether they did an evaluation and assessment***
- 3. Companies did not believe they were required to conduct an evaluation***
- 4. Companies did not perform an assessment because they consummated a reverse merger or were a shell company***
- 5. Companies appear to have performed an assessment but did not disclose a conclusion***

This past summer, the staff in the Division conducted targeted reviews of the disclosures for management's assessment of internal control over financial reporting (Item 308 of Regulation S-K) specifically focused on the non-accelerated filers that had performed an evaluation and assessment for the first time in 2007. Some of the more significant deficiencies noted regarding compliance were as follows:

1. In certain circumstances, companies disclosed that they did not *complete* their evaluation because they were unable to finish due to insufficient time or resources.
2. In many cases, companies did not include any disclosure that explicitly stated whether or not they conducted an evaluation or what the conclusions were. We have found that in certain cases, registrants had forgotten to include the disclosure because it was a new requirement for them or were confused about the distinction between internal control over financial reporting and disclosure controls and procedures and that two separate assessments are required.
3. For various reasons, certain companies incorrectly did not believe that they were required to conduct an evaluation. Among various reasons, some inappropriately concluded they were newly public companies (but were not based upon Release 33-8760) and others believed that the requirement was still deferred.
4. A limited number of companies did not complete an assessment because they did not think it applied to shell companies or they were a shell company that recently completed a reverse merger with an operating company. These companies are not newly public companies; therefore, absent any discussions with the staff on this topic, these companies are required to comply with Section 404(a) of the Sarbanes-Oxley Act of 2002.
5. Finally, some companies indicate in their disclosure that they DID conduct an evaluation of internal control over financial reporting but did not disclose their conclusion regardless of whether they had disclosed material weaknesses or not.

## ***Comment Letters***

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- ❖ **Comments sent to numerous registrants who did not comply with Section 404(a)**
- ❖ **Assessment must be completed and filing must be amended**
- ❖ **Exclusion of management's report is a material deficiency**
  - ◆ **Company is not considered timely or current for use of certain forms**
  - ◆ **Question 115.02 of Regulation S-K Compliance and Disclosure Interpretations**

In each of the cases discussed on the previous slide, we had requested that the companies amend their annual report to include the appropriate disclosures in full compliance with Section 404(a) of the Sarbanes-Oxley Act of 2002. It is the Staff's view that exclusion of management's report represents a material deficiency in the filing and these companies would not be deemed to be current or timely for purposes of certain form eligibility. This issue was addressed by the Office of Chief Counsel in their Compliance and Disclosure Interpretation on Regulation S-K (<http://www.sec.gov/divisions/corpfin/cfguidance.shtml#regs-k>).

## *Other Staff Observations*

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- **Conclusions**

- ❖ **Two conclusions are required (DCP and ICFR)**
- ❖ **Must explicitly state whether they are effective or ineffective**

- **Material Weakness Disclosures**

- ❖ **Is not transparent to allow reader to determine pervasiveness and impact on financial statements**
- ❖ **“Lagging Indicator”**
- ❖ **Narrowly focused on financial statement line item**
  - ❖ **e.g. “material weakness related to income taxes”**
- ❖ **Remediation disclosures identify additional material weaknesses or broader impact**

As was mentioned on the prior slide, we would like to reiterate that the conclusions related to internal control over financial reporting are separate and distinct (albeit they may be related) from the conclusions regarding the effectiveness of disclosure controls and procedures. Similar to that assessment, it is imperative that registrants explicitly state whether internal control over financial reporting is effective or ineffective with no qualifying language or scope limitations (other than those expressly permitted in the FAQ document).

As it relates to both accelerated and nonaccelerated filers, the Staff continues to comment on and observes areas where disclosures of material weaknesses can be improved. Disclosures of material weaknesses should be robust enough to provide some transparency into the pervasiveness and impact a particular material weaknesses could have on the financial statements. Such disclosures may indicate the individual line items that may be impacted by the weakness, the potential magnitude of the impact as well as the likelihood.

Some believe that the material weaknesses disclosures are not as useful as they could be, because companies are often only identifying material weakness once they have found an error rather than alerting investors in advance. When evaluating whether deficiencies are in fact material weakness, companies may consider more carefully analyzing the likelihood that the deficiency could fail to prevent a material error.

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

## *Other Staff Observations*

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- **Identification of Acceptable Framework**
  - ❖ **Management's Guidance is not a framework**

One last area in which we continue to see inadequate disclosure or a lack of understanding by smaller reporting companies relates to the framework on which they are basing their evaluation. In adopting release related to the assessment of ICFR, 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. Management’s Guidance highlighted two other frameworks that met the characteristics outlined in the adopting release and encourages companies to examine and select a framework that may be useful in their own circumstances. It is important to note, however, that the guidance itself is not a framework

## *Overview of Management's Assessment*

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- **Overview**
  - ❖ **Phase 1**
    - ❖ *Identify the financial reporting risks and the controls that adequately address these risks*
  - ❖ **Phase 2**
    - ❖ *Determine the evidence needed to support the assessment, based on an evaluation of ICFR risk, and evaluate the operating effectiveness of the controls identified in Phase 1*
  - ❖ **Phase 3**
    - ❖ *Report on the effectiveness of ICFR and disclose any material weaknesses identified during the evaluation process*

The objective of internal control over financial reporting is to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP. The purpose of the evaluation is to provide management with a reasonable basis for its annual assessment as to whether any material weaknesses in ICFR exists as of the end of the fiscal year.

How companies design ICFR to provide reasonable assurance the financial statements are in accordance with GAAP may be different based upon size, organization, structure, etc. As a result, the method of evaluating those controls may be different.

Management's Guidance provides a tool for management in completing this evaluation allow flexibility and scalability based upon the particular company being evaluated. Management has always had a responsibility to maintain internal controls under the Foreign Corrupt Practices Act so the focus should be on what is in place already and not involve designing new internal controls.

There are three phases in completing management's assessment:

- Phase 1 involves identifying the financial reporting risks and the controls that adequately address these risks. In this phase, management needs to consider the sources and potential likelihood of misstatements and identify controls that address those financial reporting risks.
- Phase 2 involves evaluating the operating effectiveness of the controls identified in Phase 1, and determining the evidence needed to support the assessment based on the assessment of risk associated with the controls and the financial statement elements to which they relate.
- Phase 3 involves reporting on the effectiveness of ICFR and disclosing all material weaknesses identified in the process.

# *SEC Interpretive Guidance for Management*

## •Key Attributes

- ❖ Principles-based
- ❖ Directs efforts to highest risks of material misstatement of financial statements
- ❖ Allows evaluation processes tailored to facts and circumstances
- ❖ Provides guidance on supporting evidence and documentation
- ❖ Provides guidance for evaluating deficiencies
- ❖ Does not replace control frameworks
- ❖ Voluntary

Key things considered in developing the interpretive guidance were:

Principles-based guidance – The guidance does not provide detailed instructions on how management should approach its evaluation. Rather than mandate how much something should be tested or guidance on sample size, the interpretive guidance highlights the overriding principles that can be scaled to various companies.

Directs effort to the highest risks of material misstatement of financial statements – The guidance employs a top-down risk based approach. The guidance allows companies to focus their efforts on those areas that management has identified as posing the greatest risks of material misstatements in the financial statements.

Allows evaluation process tailored to facts and circumstances – Allows a company to scale its assessment to its particular facts and circumstances, which involves considering what controls management has in place to provide reasonable assurance that financial statements are prepared in accordance with GAAP.

Provides guidance on supporting evidence and documentation -- Item 308 requires that management maintain reasonable support for its assessment. Management guidance provides direction on the supporting evidence and documentation that management should maintain to support its assessment. It outlines that the nature and extent of evidence necessary to support management's assessment should vary based on the level of risk. In addition, with regards to documentation, the guidance outlines that management's support should include documentation of the design of controls management has placed in operation to address financial reporting risks, and the basis for management's assessment, including documentation of the methods and procedures it utilizes to gather and evaluate evidence and how management formed its conclusion about the effectiveness of the company's ICFR. The guidance does not prescribe any particular type or nature of documentation. In fact, documentation may consist of things that management already has in place – manuals, policies, email of instructions, etc. In addition, documentation should focus on the controls that management concludes are adequate to address the financial reporting risks – not documentation of all controls.

Provides guidance for evaluating deficiencies – The guidance provides considerations for evaluating control deficiencies and determining whether they are significant or represent material weaknesses. The guidance also includes situations that, if they exist, management should consider whether they indicate that a deficiency exists and if so whether it represents a material weakness. Significant deficiencies and material weaknesses are reported to the audit committee and external auditor and material weaknesses are disclosed in management's report.

Management's Guidance is not a framework – As mentioned previously, companies cannot reference Management's Guidance as a framework in management's assessment or in an audit report. They must still rely on another framework such as COSO and understand that the guidance is just to facilitate the assessment.

As discussed before, the use of Management Guidance is voluntary but we believe it is a useful tool to assist management in utilizing a top-down risk based approach to their assessment



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## *Resources*



## *Resources*

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**SEC Website – [www.sec.gov](http://www.sec.gov)**

- ❖ **Information for Accountants - [www.sec.gov/about/offices/oca.htm](http://www.sec.gov/about/offices/oca.htm)**
- ❖ **Information for Small Businesses - [www.sec.gov/info/smallbus.shtml](http://www.sec.gov/info/smallbus.shtml)**
- ❖ **Division of Corporation Finance - [www.sec.gov/divisions/corpfm.shtml](http://www.sec.gov/divisions/corpfm.shtml)**

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## *Questions???*

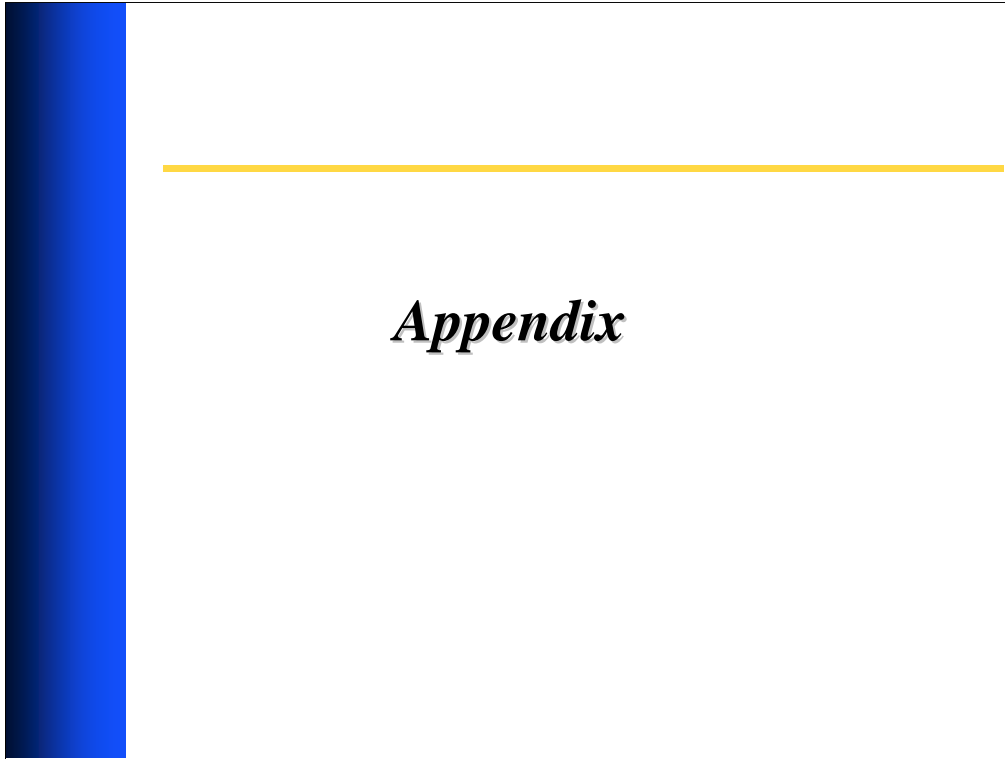
### *Key Telephone Numbers*

**DCF Chief Accountant's Office (202) 551-3400**

**DCF Office of the Chief Counsel (202) 551-3500**

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

**Office of Small Business Policy (202) 551-3460**



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

## ***Financial Statement Classification***

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

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

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

## ***Financial Statement Classification***

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

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

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

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

## ***General Reporting Requirements***

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

- ❖ **Financial Statements must be current as of the date of the filing**
- ❖ **Financial statements must be as of a date less than 135 days to be declared effective**
- ❖ **If the smaller reporting companies effective date falls after 45 days but within 90 days of the fiscal year end, audited financial statements are not required provided the following:**
  - ◆ **If a reporting company, all reports must have been filed**
  - ◆ **Company expects to report income from continuing operations before taxes for the current year**
  - ◆ **Company has reported income from continuing operations before taxes in at least one of the two previous years**

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

## ***Disclosure Controls and Procedures***

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❖ **Item 307 of Regulation S-K**

***Disclosure controls and procedures means controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the Act is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Act is accumulated and communicated to the issuer's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.***

## ***Common DC&P Comment Areas***

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### ***Insufficient conclusions***

- ❖ Disclosure should state DC&P conclusion in clear and unqualified language – effective or not effective
- ❖ “Adequate” or “Effective except for...” are inappropriate

### ***Incomplete definition of DC&P***

- ❖ If definition is included, should conform exactly to Item 307 of Regulation S-K
- ❖ However, definition is not required

### ***“Reasonable assurance” language***

- ❖ Disclosures regarding design and conclusion on DC&P should be consistent with conclusion

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