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Smaller Company Matters: The SEC's Perspective

October 12, 2010

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Today's Presentation

Today's program is designed to provide you with first-hand perspectives from the SEC on financial reporting issues facing smaller issuers and their independent accountants:

- Recent Developments
- The Comment Letter Process
- Financial Reporting Issues Frequently Raised in Comment Letters
- SEC Resources

Today's Panelists

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SEC Staff Perspective on Financial Reporting Issues Facing Smaller Issuers and their Independent Accountants

October 12, 2010

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Overview

Overview

Mission – “To see that investors are provided with material information in order to make informed investment decisions — both when a company initially offers its stock to the public and on a regular basis as it continues to give information to the marketplace.”

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

Organization

- ❖ **11 industry groups**
- ❖ **Legal and Regulatory Policy Offices**

Recent Developments

Key SEC Developments

Commission Actions

- ❖ **Dodd-Frank Act Rulemaking and Studies**
 - SEC seeking comment on regulatory initiatives required by Dodd-Frank Act
 - Elimination of ICFR attestation requirement for non-accelerated filers
- ❖ ***Commission Statement in Support of Convergence and Global Accounting Standards***
 - ❖ Two Notices of public comment on consideration of incorporating IFRS into the financial reporting system for U.S. issuers
- ❖ ***Short-Term Borrowings Proposed Rule and Interpretive Release***

Key SEC Developments

Staff Initiatives

- ❖ **Division of Corporation Finance Financial Reporting Manual Updates**
- ❖ **Sample letter Sent to Public Companies Asking for Information Related to Repurchase Agreements, Securities Lending Transactions, or Other Transactions Involving the Transfer of Financial Assets**
- ❖ **Division of Corporation Finance Compliance and Disclosure Interpretations**
- ❖ **Non-GAAP Financial Measures**

Non-GAAP Financial Measures

Staff guidance (2003 FAQ) revised because:

- ❖ Resulted in registrants excluding potentially useful information reported in places other than filings (e.g., earnings releases, websites)
- ❖ Wide diversity in application
- ❖ Opportunity to consolidate and add to guidance

Highlights of the changes

- ❖ FAQ 8 “management use” model was not incorporated into revised guidance
- ❖ Determination as to whether per share presentation is appropriate was clarified - based on whether measure is liquidity (no) or performance (yes)
- ❖ Constant currency presentation guidance simplified
- ❖ Expanded “expressly permitted” for foreign private issuers
- ❖ New income tax disclosures
- ❖ Staff will continue to seek clarifying disclosures, if necessary, and object to misleading presentations

The Comment Letter Process

Comment Letter Process

Filings Subject to Staff Review

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

Comment Letter Process

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

Comment Letter Process

Best Practices for Resolving Issues

- ❖ **Prepare a thorough response**
 - **Explain your position -- Do not immediately assume staff disagrees with accounting treatment**
 - **i.e. Disclosure may not provide sufficient information to evaluate**
 - **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**
- ❖ **Furnish all correspondence with the Staff on EDGAR**

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

Financial Reporting Issues Frequently Raised in Comment Letters

- ❖ *Management's Discussion & Analysis*
- ❖ *Reverse Mergers & "Back Door" Registrations*
- ❖ *Business Combinations*
- ❖ *Predecessor Financial Statements*
- ❖ *Goodwill, Intangible and Long-Lived Assets*
- ❖ *Equity Transactions*
- ❖ *Embedded Conversion Options and Freestanding Warrants*
- ❖ *Revenue Recognition*
- ❖ *Smaller Reporting Company Status*
- ❖ *Disclosure Controls and Procedures*
- ❖ *Internal Control over Financial Reporting*
- ❖ *Form 8-K*

Management's Discussion & Analysis (MD&A)

Release Nos. 33-6835 and 33-8350

Results of Operations

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

Liquidity

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

Early warning disclosures – Item 303(a)(3)(ii) of Regulation S-K

Reverse Mergers & “Back Door” Registrations

What is a “back door” registration?

Frequent Areas of Comment:

- ❖ **Required Form 8-K items not filed**
 - **Including Item 4.01 Form 8-K (Change in Accountants)**
- ❖ **Form 10-type information in Form 8-K**
 - **Financial Statements due within 4 business days (no 71-day extension)**
- ❖ **Financial statement updates on Form 8-K**
 - **Staff Interpretation of Exchange Act Rule 13a-1**
- ❖ **Internal Control over Financial Reporting**
 - **Regulation S-K Compliance and Disclosure Interpretation 215.02**

Reverse Mergers & “Back Door” Registrations

Illustration of Staff Interpretation of Rule 13a-1

- ❖ **Reverse Merger occurs in January 2010**
- ❖ **Both the public shell company (accounting acquiree) and nonpublic operating company (accounting acquirer) have calendar year-ends**
- ❖ **12/31/09 Form 10-K would include the financial statements of the public shell company**
- ❖ **Financial Statements of the operating company included in the Form 8-K would only include 12/31/08 audited financial statements and 9/30/09 unaudited interim financial statements**
- ❖ **3/31/10 Form 10-Q would include financial statements of the operating company**
- ❖ ***Issue* – The 12/31/09 annual financial statements of the operating company were never filed**
- ❖ ***Solution* – File an amended Form 8-K containing all information that would be required had the operating company filed a 12/31/09 Form 10-K**
- ❖ ***NOTE:* Both 2009 (i.e. shell) and 2010 (i.e. OpCo) Forms 10-K would need to comply with SOX 404 requirements**
- ❖ **See FRM Paragraph 12220.1**

Reverse Mergers & “Back Door” Registrations

Accounting acquirer’s audited F/S presented for all historical periods in subsequent reports

- ❖ **Earnings per share recast to reflect exchange ratio**
- ❖ **Eliminate retained earnings of shell or legal acquirer**
- ❖ **Common stock of shell or legal acquirer continues**

Audit Issues

- ❖ **PCAOB Standards**

Business Combinations

Determination of Accounting Acquirer

- ❖ Consideration of all factors (ASC 805-10-55-11 to 15)

Purchase Price Allocation

- ❖ Allocated to all assets and liabilities acquired generally based upon fair value
 - Consider all separately identifiable intangible assets
- ❖ Fair value of securities issued

Contingent Consideration

Disclosures and Separate Financial Statements

- ❖ Business vs. Asset Determinations
- ❖ Rule 3-05/8-04 of Regulation S-X

Predecessor Financial Statements

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

Predecessor Financial Statements

Example

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

Predecessor Financial Statements

Example (Cont.)

- ❖ ***Presentation in Form 10-K for the Year Ended December 31, 2009 :***
 - **Audited financial statements of the combined company as of and for the year ended December 31, 2009, but the statements of operations and cash flows will only include the operating company from October 14, 2009.**
 - **Pre-merger audited statements of operations and cash flows of the operating company for the year ended December 31, 2008 (and 2007 if not an SRC) and the period from January 1, 2009 to October 13, 2009 (i.e. no gap in audited periods). The 2009 stub period must be audited.**
 - **Complete set of notes should be provided for each entity.**
 - **Pre-merger financial statements should be clearly labeled as predecessor financial statements.**
 - **Corresponding Managements' Discussion and Analysis**

Goodwill, Intangible and Long-Lived Assets

Goodwill and Indefinite-Lived Intangible Assets

- ❖ Allocation to reporting units
- ❖ Impairment
 - Annual testing date vs. interim impairment tests
 - 2-step testing method and how FV is estimated

PP&E and Intangible Assets

- ❖ Capitalization
- ❖ Useful lives and amortization methods
- ❖ Impairment

Goodwill, intangible assets and PP&E

Goodwill impairment considerations:

- ❖ *How the reporting units were identified*
- ❖ *Allocation of goodwill to the reporting units*
- ❖ *Determination of fair value for reporting units*
- ❖ *Reasonableness of assumptions*
- ❖ *Interim testing triggers*
- ❖ *Market capitalization compared to aggregate book value*
- ❖ *Changes in methodologies and assumptions from last test*

Goodwill, intangible assets and PP&E

For each reporting unit that is at risk of failing Step 1 ⁽¹⁾, consider disclosing the following:

- ✓ Percentage by which fair value exceeded carrying value as of the most recent step-one test***
- ✓ Amount of goodwill allocated to the reporting unit***
- ✓ Description of method and key assumptions used and how they were determined***
- ✓ Discussion of the uncertainty associated with the key assumptions and any potential events and/or circumstances that could have a negative effect***
- ✓ If none, registrant should consider making that assertion in disclosure***

(1) See SFAS 142 paragraph 19 - ASC 350-20-35-4 to 8

Equity Transactions

Fair Value Determination

- ❖ **If publicly traded in an active market, use quoted market price**
 - **If discounts are appropriate under the circumstances, they should be supported by objective evidence**
- ❖ **If stock not publicly traded in active market**
 - **Contemporaneous equity transactions with third parties**
 - **Fair value of the services or goods provided may be used to measure the transaction, if more reliable**
 - **Consider management's judgment -- ASC 820-10-35 (FSP SFAS 157-3 and 157-4)**

Embedded Conversion Options and Freestanding Warrants

Scope

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

Common Pitfalls

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

Embedded Conversion Options and Freestanding Warrants

Valuation Issues

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

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

Revenue Recognition

Policy disclosures (i.e., SAB 104)

- ❖ Avoid “Boilerplate” disclosures
- ❖ Disclosure should be specific to each of company’s revenue streams

FASB ASC 605-25 – Multiple-Element Arrangements

- ❖ Allocation of consideration

FASB ASC 605-45 – Gross versus Net Revenue Recognition

- ❖ Consider and weigh all indicators

FASB ASC 605-50 – Customer Payments and Incentives

- ❖ Recognition
- ❖ Classification

Smaller Reporting Company Status

Transition to Smaller Reporting Company status

- ❖ **Public float < \$50 million on last business day of Q2**
 - **May reflect change immediately**
 - **If public float = \$0, < \$40 million audited annual revenues**
- ❖ **Still considered an accelerated filer until Form 10-K**
 - **Attestation report on ICFR is not required in 10-K**

Smaller Reporting Company Status

Transition to larger reporting company status

- ❖ **Public float \geq \$75 million on last business day of Q2**
- ❖ **If public float = \$0, \geq \$50 million audited annual revenues**
- ❖ **May wait until Q1 of next fiscal year for disclosure purposes**
- ❖ **Accelerated filer for purposes of 10-K including inclusion of attestation report on ICFR**

Common Comment Areas on Disclosure Controls & Procedures

Conclusions

- ❖ Disclosure should state DC&P conclusion in clear and unqualified language – effective or not effective
- ❖ “Adequate” or “Effective except for...” are inappropriate
- ❖ “Effective” DC&P conclusion when ICFR conclusion is “ineffective”
- ❖ Consider reassessing conclusions upon the filing of any amendments

Incomplete definition of DC&P

- ❖ If definition is included, should conform exactly to Item Exchange Act Rule 13a-15 (note definition is not required)

Internal Control over Financial Reporting

Separate evaluation *and assessment* from evaluation of disclosure controls and procedures

Material Weaknesses

- ❖ **Nature of the material weakness (i.e. identification of the deficiency) as opposed to the accounting**
- ❖ **Impact of control deficiency on the company's financial reporting and its ICFR**
- ❖ **Detailed and specific disclosures for each material weakness identified**

Changes in Internal Control Financial Reporting

- ❖ **Change in conclusion on effectiveness should be accompanied with some change in control**
- ❖ **Avoid boilerplate disclosure**

Substantially all operations outside U.S.

Form 8-K

Frequent Item 4.01 comments

- ❖ Failure to specify whether former accountants resigned, declined to stand for re-election, or were dismissed and the date
- ❖ Identification of “going concern opinions”
- ❖ Disclosure of disagreements in through termination date
- ❖ Exhibit 16 letter
- ❖ Reverse acquisitions
- ❖ Accounting firm mergers

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**
- ❖ **See Exchange Act Form 8-K Compliance and Disclosure Interpretation 215.01**

Resources

Resources

Frequently Requested Webpages --

www.sec.gov/divisions/corpfin.shtml

❖ General

- **Filing Review Process**
- **Statutes, Rules, and Forms**
- **Compliance & Disclosure Interpretations**
- **What's New?**

❖ Information for Small Businesses -

www.sec.gov/info/smallbus.shtml

Resources

Frequently Requested Webpages (cont) --

❖ Information for Accountants -

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

- **DCF Financial Reporting Manual**
- **Staff Accounting Bulletins**
- **Publicly Released Staff Comment Letters**
- **SEC Staff Speeches**
 - **E.g. “Best Practices for Working with the SEC Staff” -**
www.sec.gov/news/speech/2009/spch120609acms.pdf
- **Letters to Industry (a/k/a “Dear CFO Letters”)**

Resources

Whom do I contact for assistance and how?

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

Resources

Formal Requests related to financial reporting

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

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

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

Questions???

Key Telephone Numbers

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

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

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

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

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