

SEC Regulations Committee
April 17, 2007 - Joint Meeting with SEC Staff
SEC Offices – Washington DC

Discussion Document C

Topic: Applying SAB Topic 1.B.3. When the Dividend to be Paid Exceeds Both the Last Twelve Months Earnings and the Proceeds from the Equity Offering

Issue: A private company may use the proceeds of an equity offering (e.g., its IPO) to pay a dividend to its promoters/owners. Similarly, a subsidiary may undertake a public offering and sale of its own equity securities with the proceeds being used to pay a dividend to its parent. How should these entities apply the guidance in SAB Topic 1.B.3 when the amount of the dividend (in excess of the last twelve months earnings) exceeds the proceeds from the equity offering?

Background: SAB Topic 1.B.3. (as interpreted by Topic 3.IV.B.2 of the SEC Staff Training Manual) requires presentation of pro forma EPS for the latest fiscal year and interim period when an issuer pays a dividend to its owners/promoters in connection with an equity offering if the dividend exceeds the company's earnings for the most recent 12 months. This pro forma disclosure is required to be included in the historical financial statements. Topic 1.B.3 and the relevant portion of the Staff Training Manual (at 3-15) are as follows:

3. Other matters

Question: What is the staff's position with respect to dividends declared by the subsidiary subsequent to the balance sheet date?

Interpretive Response: The staff believes that such dividends either be given retroactive effect in the balance sheet with appropriate footnote disclosure, or reflected in a pro forma balance sheet. In addition, when the dividends are to be paid from the proceeds of the offering, the staff believes it is appropriate to include pro forma per share data (for the latest year and interim period only) giving effect to the number of shares whose proceeds were to be used to pay the dividend. A similar presentation is appropriate when dividends exceed earnings in the current year, even though the stated use of proceeds is other than for the payment of dividends. In these situations, pro forma per share data should give effect to the increase in the number of shares which, when multiplied by the offering price, would be sufficient to replace the capital in excess of earnings being withdrawn.

B. Distributions to Promoters/Owners At or Prior to Closing of IPO [SAB IB.3]

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2. If a distribution to owners (whether already reflected in the balance sheet or not, whether declared or not) is to be paid out of proceeds of the offering rather than from the current year's earnings, pro forma per share data should be presented (for the latest year and interim period only) giving effect to the number of shares whose proceeds would be necessary to pay the dividend (but only the amount that exceeds current year's earnings) in addition to historical earnings per share. For purposes of this SAB, a dividend declared in the latest year would be deemed to be in contemplation of the offering with

the intention of repayment out of offering proceeds to the extent that the dividend exceeded earnings during the previous twelve months.

Consider the following example:

Company X, an existing SEC registrant owns 100% of the 100,000 issued and outstanding shares of Subsidiary A's common stock. Company X has decided that Subsidiary A will undertake an initial public offering of its common stock. Subsidiary A will sell 800,000 shares in the IPO for \$6.25 per share. The offering will yield total gross proceeds (i.e., before underwriting discounts and other expenses) of \$5 million. Subsidiary A will use the proceeds from its IPO together with the funds provided by a bank line of credit to pay a \$15 million dividend to Company X at the time of closing. Company A's net income for the previous 12 months was \$1 million

Question: What should Subsidiary A use as the denominator in the pro forma EPS calculation presented in its historical financial statements?

View A: 900,000 calculated as follows:

Pre-existing shares	100,000
IPO shares	<u>800,000</u>
Pro forma shares	<u>900,000</u>

The amount of the dividend that Subsidiary A will pay to Company X at the closing date of the IPO (\$15 million) exceeds Subsidiary A's net income for the previous 12 months (\$1 million). Accordingly, a portion of the dividend is deemed paid from the proceeds of the IPO. Since the amount of the dividend in excess of Subsidiary A's net income for the previous 12 months (\$14 million) exceeds the gross proceeds of the IPO (\$5 million), Subsidiary A should include all 800,000 of the shares offered in the IPO in the denominator of the pro forma EPS calculation included in the historical financial statements. In order to present a transparent picture for the investor, the numerator of the pro forma EPS computation should also be adjusted to reflect the incremental interest expense (net of tax) relating to the portion of the dividend that exceeds both the gross proceeds from the equity offering and the previous 12 months' earnings (\$9 million in this example).

View B: 2,340,000 calculated as follows:

Amount of dividend	\$15,000,000
Previous 12 mo. net income	<u>(1,000,000)</u>
Amount of dividend in excess of previous 12 mo. net income	\$14,000,000
IPO price (per share)	<u>6.25</u>
Number of shares needed to fund dividend in excess of previous 12 mo. net income	2,240,000
Pre-existing shares	<u>100,000</u>
Pro forma shares	<u>2,340,000</u>

The amount of the dividend that Subsidiary A will pay to Company X at the closing date of the IPO (\$15 million) exceeds Subsidiary A's net income for the previous 12 months (\$1 million). Accordingly, Subsidiary A must present a pro forma EPS calculation in its historical financial statements showing how many shares would be issued at the IPO price to fund the excess dividend.

Committee Recommendation: The Committee supports View A. The Committee does not believe the pro forma EPS calculation should reflect more shares than will actually be outstanding after the offering. The Committee is aware of at least one example where the staff has concluded that View B is the appropriate interpretation.

SEC Staff Response: The staff supports View A.

