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

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These slides were presented at the Forums on Auditing in the Small Business Environment hosted by the PCAOB during 2012. Participants were auditors from smaller registered public accounting firms. The slides are intended to provide a sampling of issues that the Staff of the Division of Corporation Finance (“CF” or the “Division”) frequently encounters when reviewing filings for smaller public companies as well as an overview of developments within the Division. Comments issued by the CF Staff may be different from those included here based upon individual facts and circumstances. The slides are accompanied by detailed notes that provide additional context.



## *Disclaimer*

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## *Agenda*

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



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*Overview of the  
Division of Corporation Finance*

## *Overview of the Division of Corporation Finance*

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### **What we do**

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

### **Organization**

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

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

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

The Division provides administrative interpretations of the Securities Act of 1933, the Securities Exchange Act of 1934, and the Trust Indenture Act of 1939, and related rules and regulations. The Staff provides interpretative guidance to registrants, prospective registrants, and the public to help them comply with the law and related regulations. For example, a company might ask whether the offering of a particular security requires registration with the SEC. The Division may communicate its guidance orally, or the Division uses no-action letters and interpretive letters to provide guidance on the regulations in a more formal manner.



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*Recent Developments*

# *Key SEC Developments*

## **Commission Actions**

- ❖ *Dodd-Frank Act Rulemaking and Studies*
- ❖ *JOBS Act Rulemaking and Studies*
- ❖ *Commission Statement in Support of Convergence and Global Accounting Standards*

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

The Jumpstart Our Business Startups (JOBS) Act, which was enacted on April 5, 2012, made several significant changes to the securities laws.

Title I of the JOBS Act, which was effective immediately upon enactment, creates a new category of company called an "emerging growth company," which is defined as a company with total annual gross revenues of less than \$1 billion during its most recently completed fiscal year and has either (1) not yet had or (2) had after December 8, 2011, its first sale of common equity securities pursuant to an effective registration statement under the Securities Act of 1933. A company retains its status as an emerging growth company until the earliest of the following:

- The last day of the fiscal year of the issuer during which it had total annual gross revenues of \$1 billion or more (the Commission is required to index this amount for inflation every five years);
- The date it is deemed to be a large accelerated filer under Commission rules (including a public float of \$700 million or more);

- The date on which it has issued more than \$1 billion in non-convertible debt in the previous three years; or
- The last day of the fiscal year following the fifth anniversary of the first registered sale of common equity securities of the issuer.

Accommodations available to EGCs include the following, depending on their facts and circumstances:

- Confidential submission
- Financial reporting accommodations related to:
  - Number of years of financial statements presented
  - MD&A
  - Selected financial data
- Delay in adoption of new or revised accounting standards until the date that a non-issuer would be required to comply with such standards
- Exemption from auditor attestation on internal controls over financial reporting (SOX 404(b))
- Other

Additional information about the JOBS Act can be found at <http://www.sec.gov/divisions/corpfin/cfjobsact.shtml>.

Additional information about the Commission Statement in Support of Convergence and Global Accounting Standards can be found at <http://www.sec.gov/spotlight/globalaccountingstandards.shtml>. The Final Staff Report on the *Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers* can be found at <http://www.sec.gov/spotlight/globalaccountingstandards/ifrs-work-plan-final-report.pdf>.

## *Key CF Staff Initiatives*

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- ❖ **Division of Corporation Finance Financial Reporting Manual Updates (FRM)**
- ❖ **Corporation Finance Compliance and Disclosure Interpretations (CDI)**
- ❖ **CF Disclosure Guidance Topics**
  - ❖ **Staff Observations in the Review of Forms 8-K Filed to Report Reverse Mergers and Similar Transactions**
  - ❖ **Cybersecurity**
  - ❖ **Staff Observations in the Review of Promotional and Sales Material Submitted Pursuant to Securities Act Industry Guide 5**
  - ❖ **European Sovereign Debt Exposures**
  - ❖ **Staff Observations Regarding Disclosures of Smaller Financial Institutions**
- ❖ **SEC CF Staff Review of Common Financial Reporting Issues Facing Smaller Issuers (Dec. 2011) slides**

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

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

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

SEC CF Staff Review of Common Financial Reporting Issues Facing Smaller Issuers (Dec. 2011) slides can be found at <http://www.sec.gov/news/speech/2012/spch020912co.pdf>.



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***The CF Staff Review Process***

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

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

As required by the Sarbanes-Oxley Act of 2002, the Division undertakes some level of review of each reporting company at least once every three years and reviews a significant number of companies more frequently. In addition, the Division selectively reviews transactional filings – documents companies file when they engage in public offerings, business combination transactions, and proxy solicitations. To preserve the integrity of the selective review process, the Division does not publicly disclose its review criteria.

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

## *Types of Comments*

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- ❖ **Request for additional supplemental information**
- ❖ **Provide additional or different disclosure in a future filing**
- ❖ **Amend filing to revise financial statements or disclosure**
- ❖ **Completion of review letter**

The Division's comments are in response to a company's disclosure and other public information and are based on the CF Staff's understanding of that company's facts and circumstances. Make sure you understand the type of response we are looking for. We usually issue three types of comments: (1) request for additional information; (2) request for additional or clarifying disclosure in a future filings; or (3) request for amendment of the filing to revise financial statements or disclosure. If you do not understand which type of comment we issued, give us a call.

A company is generally expected to respond in writing to each comment in a letter from the CF Staff. A company's explanation or analysis of an issue will often satisfactorily resolve a comment. Depending on the nature of the issue, the CF Staff's concern, and the company's response, the CF Staff may issue additional comments following its review of the company's response to its prior comments. This comment and response process continues until the CF Staff and the company resolve the comments. In some cases, it may be necessary to amend a previously filed report or other filings as the result of comments.

Once we complete our review, we typically send the company a letter indicating we have completed our review and have no further comments. The SEC publicly releases comment letters and response letters no earlier than 20 business days following the completion of the review of the filing.

In the event that a company does not respond to a comment letter or staff inquiries, we will consider what additional actions may be necessary in order to resolve the issues raised in our comment letter. If we are unable to satisfactorily communicate with the company, we may eventually issue a “review termination letter” that includes a ten day deadline for response. This letter explains that, in the event the company does not provide a response, the staff will consider how to resolve any outstanding issues. Among other things, we may decide to release publically comment letters and response letters relating to disclosure files it has reviewed to ensure that we fulfill our investor protection responsibilities.

## *Best Practices*

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- ✓ **Submit all correspondence with the Staff on EDGAR**
- ✓ **Document your decision-making contemporaneously**
- ✓ **Respond promptly**
- ✓ **Make responses comprehensive**
- ✓ **Pick up the phone and give us a call**

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

It may be easier to respond to comments if you have documented your significant accounting decisions along with the literature you relied upon, the alternatives considered, and the basis for your conclusions, contemporaneously with the transaction. Going through this process at the time of the transaction will allow you to respond more efficiently and effectively to CF Staff comments.

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

Companies should respond to all comments in the letter, including all parts of the comment. We sometimes send a follow up letter since some portions of our original comment letter were not fully addressed.

If you do not understand what is being asked in the comment letter, pick up the phone and call us. Our phone numbers are located in the last paragraph of our comment letters. We generally appreciate if you could schedule a conference call in advance. It allows us time to prepare for the call - so we can make the call as productive as possible. We also encourage you to invite all interested parties to the first call to eliminate the need to repeat information in any subsequent calls.



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*Frequent CF Staff Comment Areas*

## ***Frequent CF Staff Comment Areas***

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- ❖ **Reverse Mergers**
- ❖ **Disclosure Controls and Procedures, Internal Control over Financial Reporting and Certifications**
- ❖ **Equity Transactions**
- ❖ **Stock Compensation**
- ❖ **Embedded Conversion Options and Freestanding Warrants**
- ❖ **Deferred Tax Valuation Allowances**
- ❖ **Form 8-K – Items 4.01 and 4.02**
- ❖ **Audit Reports**
- ❖ **Smaller Reporting Company Status**

This is not a pre-determined list of staff focus. When we review a registrant's filings we are literally "reviewing that registrant." Any comments that result are specific to the registrant, including its current circumstances, what is happening in its industry and any other relevant factors.

## *Reverse Mergers*

### ***Frequent Areas of Comment:***

- ❖ **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**
- ❖ **Required Form 8-K items not filed**
  - **Including Item 4.01 Form 8-K (Change in Accountants)**
- ❖ **Internal Control over Financial Reporting**
  - **Regulation S-K Compliance and Disclosure Interpretation 215.02**

Reverse mergers refers to a private operating company merging with a public shell company. This method of registration is reported on a Form 8-K rather than a 1933 Act registration statement. There are several accounting and reporting complexities with these transactions. They can be problematic in the review process because at the time the CF Staff reviews these transactions, the Form 8-K has already been filed and the transaction has been consummated.

In certain circumstances, the due date or filing date of the Form 8-K, whichever is earlier, occurs after the end of the private company's most recently completed annual or quarterly period, but before financial statements for that annual or quarterly period would be required to be presented in a Form 10. In these circumstances the financial statements of the private operating company required by Items 2.01(f) and 9.01 of Form 8-K may not include the private company's most recently completed annual or quarterly period. The registrant, however, remains subject to Exchange Act Rules 13a-1 and 13a-13, or 15d-1 and 15d-13, requiring annual and quarterly reports, respectively. The registrant must file its applicable annual and quarterly reports. Additionally, the registrant must file an amended Form 8-K with the financial statements of the private operating company's most recently completed annual or quarterly period prior to the date of the reverse recapitalization, as applicable, within the number of days applicable based on the shell company's filing status (60, 75, and 90 days for annual periods and 40, 40, and 45 days for interim periods for large accelerated, accelerated, and non-accelerated filers, respectively) after the private operating company's period end.

Unless the same audit firm audited both the registrant and the accounting acquirer, a reverse merger always results in change of accountants for purposes of Item 4.01 of Form 8-K.

While the historical financial reporting for pre-transaction periods may change to that of the private operating company once the transaction has occurred, the registrant has not changed in this transaction. It is still the public shell company, and therefore is not a newly public company for purposes of SOX 404. However, CF Staff has issued a CDI to provide guidance to companies that find themselves in this situation. It acknowledges that it might not always be possible to conduct an assessment of the private operating company or accounting acquirer's internal control over financial reporting in the period between the consummation date of a reverse acquisition and the date of management's assessment of internal control over financial reporting required by Item 308(a) of Regulation S-K. It also recognizes that in many of these transactions, such as those in which the legal acquirer is a non-operating public shell company, the internal controls of the legal acquirer may no longer exist as of the assessment date or the assets, liabilities, and operations may be insignificant when compared to the consolidated entity. Therefore, CF Staff does not object if the registrant excludes management's assessment of internal controls over financial reporting ("ICFR") in the Form 10-K covering the fiscal year in which the transaction was consummated. However, this CDI would not apply if the company had to file an amended Form 8-K under the Rule 13a-1 interpretation discussed above.

## **Illustration of CF Staff Interpretation of Rule 13a-1**

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- ❖ **Reverse merger occurs on February 1, 2012**
- ❖ **Non-accelerated shell (accounting acquiree) and private operating company (accounting acquirer) have calendar year-ends**
- ❖ **Audited f/s of the private op co for the y/e 12/31/10 and the unaudited f/s for the interim period ended 9/30/10 and comparable prior periods would be filed on Form 8-K (within 4 business days of the transaction - no 71-day extension)**
- ❖ **Registrant would file its annual report on Form 10-K for the y/e 12/31/11 within 90 days after 12/31/11**
- ❖ **Registrant would file the same info required in a Form 10-K of the private op co in an amended Form 8-K by the same Form 10-K due date – 90 days after 12/31/11.**
- ❖ **See FRM Section 12220.1**

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

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

## ***Reverse Mergers & “Back Door” Registrations***

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### ***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 registered audit firm
- ❖ PCAOB Standards

Under current accounting literature, the acquisition of a private operating company by a non-operating public shell company is considered by the CF Staff to be a capital transaction in substance rather than a business combination (it is outside the scope of FASB ASC Topic 805). That is, the transaction may be viewed as a reverse recapitalization — issuance of stock by the private operating company for the net monetary assets of the public shell company accompanied by a recapitalization. In order to reflect the change in capitalization, earnings per share should be recast for all historical periods to reflect the exchange ratio. The common stock account of the public shell continues post-merger, while the retained earnings of the shell company should be eliminated as the historical operations are deemed to be those of the private operating company.

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

## ***Reverse Mergers & “Back Door” Registrations***

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### ***Recapitalization Example:***

- ❖ The transaction was consummated 4/1/12
- ❖ Shell has 100,000 shares o/s @ 3/31/12 (\$1 par)
- ❖ Shell has stockholders equity of \$125,000 @ 3/31/12
- ❖ OpCo has 100,000 shares o/s @ 3/31/12 (\$2 par)
- ❖ Shell issues 400,000 shares for 100% of OpCo
- ❖ Post-recap entity has no other equity transactions from 4/1/12 – 6/30/12
- ❖ Post-recap entity has net income of \$300,000 for the period from 4/1/12 – 6/30/12

Slides 18 through 20 provide a summarized example of reporting for a “back door” registration statement accounted for as a recapitalization.

## *Reverse Mergers & “Back Door” Registrations*

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**OpCo SSE 1/1/11 -  
3/31/12**

	Number of Shares	Shares at Par (\$2)	APIC	Retained Earnings (Deficit)	Total
1/1/11	60,000	120,000	600,000	300,000	1,020,000
Shares issued for services 7/1/11	20,000	40,000	110,000		150,000
Net Income				<u>250,000</u>	<u>250,000</u>
12/31/11	80,000	160,000	710,000	550,000	1,420,000
Shares issued for cash 2/1/12	20,000	40,000	190,000		230,000
Net Income				<u>200,000</u>	<u>200,000</u>
3/31/12	<u>100,000</u>	<u>200,000</u>	<u>900,000</u>	<u>750,000</u>	<u>1,850,000</u>

## *Reverse Mergers & “Back Door” Registrations*

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### **Post-Recapitalization Continuing Entity SSE 1/1/11 - 6/30/12**

	Number of Shares	Shares at Par (\$1)	APIC	Retained Earnings (Deficit)	Total
1/1/11	240,000	240,000	480,000	300,000	1,020,000
Shares issued for services 7/1/11	80,000	80,000	70,000		150,000
Net Income				250,000	250,000
12/31/11	320,000	320,000	550,000	550,000	1,420,000
Shares issued for cash 2/1/12	80,000	80,000	150,000		230,000
Net Income				200,000	200,000
3/31/12	400,000	400,000	700,000	750,000	1,850,000
Recapitalization 4/1/12	100,000	100,000	25,000		125,000
Net Income				300,000	300,000
6/30/12	500,000	500,000	725,000	1,050,000	2,275,000

## ***Disclosure Controls & Procedures (DC&P)***

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### ***Conclusions***

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

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

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

CF Staff continues to issue comments on the evaluation of disclosure controls and procedures in quarterly and annual reporting. Item 307 requires companies to “disclose the conclusions of the registrant’s principal executive and principal financial officers...regarding the effectiveness of the registrant’s disclosure controls and procedures...” Registrants should be aware that the definition of disclosure controls and procedures is broader than the definition of internal control over financial reporting (internal control over financial reporting is generally subsumed in disclosure controls and procedures) so it is possible that disclosure controls and procedures can be ineffective even while internal control over financial reporting is effective. However, the CF Staff may ask the company to support a conclusion that disclosure controls and procedures are effective when internal control over financial reporting is ineffective.

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

## ***Management Reports under Item 308(a) of S-K***

- ❖ **Separate evaluation and assessment from evaluation of disclosure controls and procedures**
- ❖ **Item 308 (a) disclosures**
  - **Large accelerated and accelerated filers that are not EGCs—comply with all 4 elements**
  - **Non-accelerated filers and EGCs – comply with first 3 elements unless voluntarily include auditor report under Item 308(b) of S-K, in which case comply with all four elements.**

## ***Auditors Reports under Item 308(b) of S-K***

- ❖ **Only required for non- EGCs that are accelerated or large accelerated filers**

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

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

While there is significant overlap between the definition of disclosure controls and procedures and internal control over financial reporting, the conclusions related to internal control over financial reporting are separate and distinct from the conclusions regarding the effectiveness of disclosure controls and procedures. In this regard, the rules require that registrants explicitly state whether internal control over financial reporting is effective or ineffective with no qualifying language or scope limitations. The CF Staff generally asks companies to amend their filings when it appears they have not completed an assessment, they have not disclosed their conclusion on effectiveness, or they have concluded that internal control over financial reporting is effective when material weaknesses exist.

From a compliance perspective, companies that are subject to the auditor attestation requirement or voluntarily comply must disclose all four elements required by Item 308(a) of Regulation S-K (non-accelerated filers and EGCs must only disclose the elements relevant for their purposes). As it relates to the framework, the Commission specified the characteristics of a suitable control framework and identified the “Internal Control – Integrated Framework (1992)” created by COSO as an example of a suitable framework. The *Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934* or “Management’s Guidance” highlights two other frameworks that meet the characteristics outlined in the adopting release and encourages companies to examine and select a framework that may be useful in their own circumstances. It is important to note, however, that the Management’s Guidance itself is not a framework.

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

***Disclosures that companies should consider when material weakness exists (see SEC Release No. 33-8810)***

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

### ***Material changes in ICFR***

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

The CF Staff continues to comment on and observe areas where disclosures of material weaknesses can be improved. Disclosures of material weaknesses are most useful if they provide some transparency into the pervasiveness and impact a particular material weakness could have on the financial statements. The CF Staff often sees material weaknesses that are narrowly focused on one particular financial statement line item in which an error was discovered. For example, a company may disclose that it has material weaknesses related to its accounts receivable. Not only does this disclosure not specifically address the internal controls in which there are weaknesses, it does not consider the impact that the weakness could have on other financial statement line items. Similar questions may also arise through a review of remediation disclosures. For example, the remediation disclosures may indicate that the registrant is improving internal controls that go well beyond and impact more areas than the narrow material weakness disclosed.

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

## ***ICFR For Registrants With Substantially All Their Operations Outside U.S.***

**Background and training of CFO or other person(s) responsible for maintaining books and records and preparing financial statements**

### ***Seek information:***

- **U.S. GAAP education and ongoing training**
- **Professional qualifications**
- **Specific nature of U.S. GAAP experience**
- **Specific roles / duties of person with U.S. GAAP experience**
- **Services performed by a third party CPA or consultants – specific nature, extent, and qualifications**

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

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

# *Equity Transactions*

## **Fair Value Determination – ASU 2011-04**

- ❖ **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**
  - a) Use quoted price in an active market for the identical item held by another party
  - b) Use observable inputs, such as quoted market price in a market that is not active
  - c) If (a) and (b) not available, valuation technique (e.g. income approach or market approach)

## **Disclosure**

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

When smaller companies incorrectly determine fair value for equity issued to consummate certain transactions, such as compensation arrangements and business combinations, it can often lead to material misstatements. CF Staff will frequently comment when a registrant has used a value different from quoted market price to value its equity if it is evident that the stock trades in an active market. GAAP explicitly prohibits the application of blockage discounts. Discounts for trading restrictions may be appropriate in certain circumstances provided they are characteristics of the security and can be supported with objective evidence.

If the stock does not trade in an active market, the CF Staff may look to cash transactions with third parties for the same security in close proximity to support determination of fair value or otherwise may consider whether the fair value of the services and/or goods received is more reliable. While quoted market price may not be the appropriate measure of fair value in inactive markets, that price should not be ignored when determining fair value. Absent market prices in an active market or other objective measures of fair value, management should use its judgment in considering the fair value hierarchy in determining a fair value that is supportable. Because of the significant impact that fair value determinations can have on the financial statements, it is helpful for registrants to provide disclosure surrounding how the fair value was determined and whether they used contemporaneous or retrospective valuations.

## *Stock-Based Compensation*

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- ❖ **Disclosure requirements under ASC 718-10-50-1 and 2**
- ❖ **Valuation prior to IPO (“cheap stock”)**
  - **AICPA Practice Aid – valuation and disclosure guidance**
  - **FRM Section 9520 – provides guidance on critical accounting estimates and MD&A disclosure**
  - **FRM Section 7520.1 – disclosures when estimated fair value of stock is less than IPO price**

Disclosure requirements under ASC 718 include information to enable users of the financial statements to understand items such as the nature and terms of the arrangements, the effect of compensation costs and the method of determining fair value.

Guidance can be found in the 2004 AICPA Practice Aid; FRM Section 9520 provides guidance on disclosures companies should consider providing in MD&A; and FRM 7520.1 outlines considerations when equity awards are granted in proximity to an IPO and the estimated fair value of the stock is substantially below the IPO price.

## ***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**

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

FASB ASC Subtopic 815-40 is key to the analysis of conversion features and other equity indexed share settled features for purposes of classifying the instrument as debt or equity. When evaluating convertible debt instruments, companies must first determine whether the instrument is a conventional convertible debt instrument, as explained in FASB ASC paragraphs 815-40-25-41 and 25-42. If the instrument is a conventional convertible debt instrument then Paragraphs 815-40-25-7 through 25-35 and 815-40-55-2 through 55-6 do not apply and will not have to be evaluated, but the remaining paragraphs should still be considered.

Agreements that contain clauses to adjust the conversion price other than *standard* anti-dilution provisions that apply to *all* shareholders are not considered conventional convertible. This frequently creates problems for smaller companies. Some other common pitfalls that may lead to an embedded derivative needing to be bifurcated and accounted for as a derivative liability or a freestanding warrant being accounted for as a derivative liability are listed on the slide.

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

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

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### ***Valuation Issues***

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

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

In addition to the recognition and presentation issues addressed on the prior slides, the staff may issue comments to understand how freestanding derivatives and bifurcated embedded features have been measured. In many cases, there may be multiple embedded features or the features of the bifurcated derivatives may be so complex that a Black-Scholes valuation does not consider all of the terms of the instrument. Therefore, the fair value may not be appropriately captured by simple models. The staff may consider the reasonableness of assumptions and also whether the valuation technique used is appropriate. In some cases, we have found that the issues related to valuation arise from the terms and features not being properly defined or identified when considering the contractual agreements in their entirety.

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

## *Income Taxes – DTAs*

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**ASC 740-10-30-21**

***“Forming a conclusion that a valuation allowance is not needed is difficult when there is negative evidence such as cumulative losses in recent years.”***

We have recently seen registrants assert that they believe the current economic situation is an aberration such that they place less weight on recent historical results when determining whether a DTA is more likely than not to be realized. Whether or not the current economic situation is an aberration will likely vary based on a company’s unique facts and circumstances. However, the Staff is of the view that, in general, it would be difficult to conclude that an economic downturn is an aberration.

When considering positive and negative evidence the literature states cumulative losses in recent years are a significant piece of negative evidence when assessing deferred tax assets. Significant and objective positive evidence is required to conclude it is more likely than not a company will realize its DTAs when cumulative losses in recent years exist.

## *Form 8-K – Item 4.01 (S-K 304)*

### ❖ **Item 4.01 8-K required:**

- **Change in auditor**
- **Reverse merger**
- **Accounting firm mergers**

### ❖ **Frequent compliance issues:**

- **Exhibit 16 letter**
- **Disagreements and reportable events through the termination date**
- **Subsequent interim period**
- **Failure to specify whether former accountant resigned, declined to stand for re-election, or was dismissed**

Item 4.01 8-K is required to be filed when there is a change in auditor. A registrant may have a change in auditor for a number of different reasons, including as a result of a reverse merger or an accounting firm merger. As they relate to Item 4.01 Form 8-Ks, the CF Staff’s comments are generally focused on compliance with the item requirements.

A registrant is also required to file a letter from the registrant’s former independent accountant regarding its concurrence or disagreement with the statements made by the registrant in its Form 8-K concerning the resignation or dismissal as the registrant’s principal accountant (Exhibit 16 letter). The CF Staff may also comment if the Exhibit 16 letter has not been filed in a timely manner.

Item 304(a)(1)(iv) and (v) of Regulation S-K, require the registrant to disclose any disagreements and reportable events during the registrant’s two most recent fiscal years and any “subsequent interim period” preceding audit firm resignation, declination, or dismissal.

Item 304(a)(1)(iv) requires an affirmative disclosure if there are no disagreements but does not require affirmative disclosure of no reportable events. The filing should disclose the subject matter of any disagreements.

The CF Staff views the “subsequent interim period” since the most recent year-end for the purposes of disclosing disagreements to include the period through the termination date. As a result, the CF Staff has requested that companies revise their disclosure if the entire period is not covered already by the disclosure. See Regulation S-K CDI 111.01.

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

## ***Form 8-K – 4.02***

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### **Frequent Compliance Issues:**

- ❖ **Triggering event other than non-reliance conclusion (e.g., completion of restatement)**
- ❖ **Unclear statement regarding non-reliance**
- ❖ **Brief description of facts lacking or unclear**
- ❖ **“Stealth Restatements”**
  - ✓ **See Exchange Act Form 8-K Compliance and Disclosure Interpretation 215.01**

Item 4.02, Form 8-K requires that registrants report the conclusion that previously issued financial statements can no longer be relied upon. Staff comments will generally be focused on compliance with the item requirements. Refer to Item 4.02 for a list of requirements.

The triggering event for filing of an Item 4.02, Form 8-K should be the conclusion that previously issued financial statements can no longer be relied upon rather than the restatement of those financial statements.

Form 8-K generally allows registrants to disclose reportable items in periodic reports coming due if the event occurs within the four business days before the due date of the periodic report. Notwithstanding the general provision of Form 8-K, the CF Staff expects registrants to always report the conclusion that previously issued financial statements can no longer be relied upon under Item 4.02 on Form 8-K rather than in another periodic report as discussed in Form 8-K CDI 215.01.

# *Audit Reports*

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- ❖ ***Audit report signatures***
- ❖ ***PCAOB “auditing standards” vs. “standards”***
- ❖ ***Development stage***
  - **Cumulative amounts**
  - **Waiver process**
- ❖ ***Revoked registration with PCAOB***

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

We have noticed a fair number of audit reports referring to “auditing standards of the PCAOB” instead of “the standards of the PCAOB.” Use of the word “auditing” implies that the auditor did not comply with other standards, such as the PCAOB’s professional practice standards and the SEC’s independence standards. The PCAOB requires an issuer’s auditor to refer to the “standards of the PCAOB.” However, the PCAOB does not preclude an auditor of a non-issuer from issuing an opinion in accordance with “the auditing standards of the PCAOB,” unless the issuer’s principal auditor makes reference to the audit report covering the non-issuer.

Auditor association with cumulative amounts from inception included in a registrant’s or its predecessor’s annual financial statements is required as long as the registrant or its predecessor is in the development stage. This is premised on the fact that U.S. GAAP identifies these amounts as “additional information,” rather than supplemental information that is not required to be audited.

Where an auditor assumes responsibility for the audit of the entirety of the cumulative amounts from inception, the current auditor's report would not refer to the work of a predecessor auditor. Alternatively, a current auditor may rely on the work of a predecessor auditor (or predecessor auditors) with respect to discrete reporting periods that are part of the cumulative amounts since inception, in which case the current auditor's report must include a reference to the predecessor auditor(s) and identify the periods audited by the predecessor auditor(s) in the introductory paragraph of the audit report, and refer to the report of the other auditor in expressing the current auditor's opinion. When a current auditor refers to a predecessor auditor (or predecessor auditors) the filing must include the predecessor auditors' report(s) and, where applicable, consent(s).

If the PCAOB revokes the registration of an audit firm, audit reports issued by that firm may no longer be included in a registrant's filings made on or after the date the firm's registration is revoked, even if the report was issued before the date of revocation. Financial statements previously audited by a firm whose registration has been revoked would need to be reaudited by a PCAOB registered firm prior to inclusion in future filings or if included in a registration statement that has not yet been declared effective.

## ***Smaller Reporting Company Status***

### ***Transition from Other Reporting Company Status to Smaller Reporting Company Status***

- ❖ **Public float < \$50 million on last business day of Q2**
- ❖ **If public float = \$0, < \$40 million annual revenues**
- ❖ **Still considered an accelerated filer through the end of the fiscal year**
  - **May elect SRC reporting immediately for disclosure purposes, but subject to accelerated filer deadlines**
  - **Attestation report on ICFR is not required in 10-K**

The test for SRC status is:

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

If an issuer fails to qualify as an SRC, it is not eligible for SRC status until:

- Public float < \$50 million on last business day of Q2, or
- If public float = \$0, < \$40 million annual revenues

If a company newly qualifies as a smaller reporting company based upon its second quarter public float, it may elect to provide the scaled disclosure starting with its next quarterly report on Form 10-Q. While the company can provide the scaled disclosure immediately, it is still considered an accelerated filer through the end of the fiscal year, at which time it becomes a nonaccelerated filer.

## ***Smaller Reporting Company Status***

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### ***Transition from SRC to Other Reporting Company Status***

- ❖ Public float  $\geq$  \$75 million on last business day of Q2
- ❖ If public float = \$0,  $\geq$  \$50 million annual revenues
- ❖ Remain an SRC through fiscal year end; larger filer disclosure required starting with Q1 10-Q
- ❖ May elect SRC disclosure for 10-K and proxy statement relating to exit year BUT
- ❖ Accelerated filer for purposes of 10-K, including inclusion of attestation report on ICFR

SRC Status in Transition to Other Reporting Company Status

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

While the thresholds may align with the thresholds for filer status (i.e., nonaccelerated or accelerated), the test is for different purposes and there may be circumstances where a smaller reporting company is an accelerated filer or where a larger reporting company is a nonaccelerated filer. If a company is required to exit smaller reporting company status, it may continue to report as a smaller reporting company through the filing of the annual report on Form 10-K for that year. However, while this company may still provide scaled disclosure in the Form 10-K, if the company is an accelerated or large accelerated filer it must follow those deadlines for the Form 10-K for that year and include the attestation report on internal control over financial reporting required by Section 404(b) of the Sarbanes-Oxley Act.



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## *Resources*

## *Resources*

[www.sec.gov/divisions/corpfm.shtml](http://www.sec.gov/divisions/corpfm.shtml)

❖ **Staff Guidance and Interpretations**

❖ **Filing Review Process**

❖ **Compliance & Disclosure Interpretations**

❖ **Disclosure Program Updates**

❖ **Division Announcements**

❖ **Statutes, Rules, and Forms**

❖ **Information for Small Businesses**

[www.sec.gov/info/smallbus.shtml](http://www.sec.gov/info/smallbus.shtml)

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

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

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

# *Resources*

## **Information for Accountants**

[www.sec.gov/divisions/corpfin/cfreportingguidance.shtml](http://www.sec.gov/divisions/corpfin/cfreportingguidance.shtml)

- **Division of Corporation Finance Financial Reporting Manual**
- **Division of Corporation Finance Compliance & Disclosure Interpretations**
- **Staff Accounting Bulletins**
- **Corporation Finance Comment Letters**
- **Corporation Finance Filing Review Process**
- **Other Frequently Requested Material**
  - **Presentation from last year's Forums**
  - **Dear CFO Letters and Other Disclosure Guidance**
  - [CF Disclosure Guidance Topics](#)

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

Comment letters issued by the CF Staff to specific registrants and their corresponding responses can be accessed at <http://www.sec.gov/answers/edgarletters.htm>. The SEC publicly releases comment letters and response letters. Beginning January 1, 2012, the CF Staff started releasing filing review correspondence no earlier than 20 business days following the completion of the review of the filing.

Selected CF Staff speeches, which are non-authoritative guidance given by staff in the Division and the Office of the Chief Accountant, can also be found on the CF website. In addition to these speeches, smaller issuers and their auditors may find the CF "Filing Review Process" memo helpful. The "Dear CFO Letters" are sample letters sent to certain companies to address emerging disclosure issues for consideration in advance of preparing disclosures. The letters are posted to the website with the intent of being useful to a broader population of registrants.

## *Resources*

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### ***Whom do I contact for assistance and how?***

- ❖ **Comment process - Disclosure Operations CF Staff**
  - Names and number will be on comment letter
  
- ❖ **Staff interpretation or informal question**
  - **Financial Reporting - CF Office of Chief Accountant at (202) 551-3400 or submit request through online form at [https://tts.sec.gov/cgi-bin/corp\\_fin\\_interpretive](https://tts.sec.gov/cgi-bin/corp_fin_interpretive)**
  - **U.S. GAAP - SEC Office of the Chief Accountant at 202-551-5300 or [OCA@sec.gov](mailto:OCA@sec.gov)**
  - **Small Business Policy - CF Office of Small Business Policy (202) 551-3460**
  - **Interpretive questions - CF Office of Chief Counsel at 202-551-3500**
  - **EDGAR questions - EDGAR Filer Support at 202-551-8900**

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

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

## *Resources*

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### ***Formal Requests related to financial reporting***

- ❖ Pre-filing accommodations/waivers/interpretations of reporting requirements
- ❖ Address to the CF Chief Accountant
- ❖ Mail or email to [dcaoleters@sec.gov](mailto:dcaoleters@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](mailto:OCA@sec.gov)***

- ❖ [www.sec.gov/info/accountants/ocasubguidance.htm](http://www.sec.gov/info/accountants/ocasubguidance.htm)

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

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



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## *Questions*

***Key Telephone Numbers:***

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

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

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

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