CURRENT DEVELOPMENTS IN THE DIVISION OF CORPORATION FINANCE

National Conference on Current SEC & PCAOB Developments
December 6, 2005
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Corporation Finance

Overview

Financial Reporting and Disclosure Issues
OVERVIEW

Craig Olinger
Overview

FYE September 30, 2005
Over 6000 issuer reviews
(51% of issuers)

26.1 days average time for initial comments on registration statements
Overview
Overview

AD Offices - 4 New ACAs

Structured Finance, Transportation & Leisure:

Lyn Shenk
Financial Services

Amit Pande
Electronics & Machinery

Kate Tillan
Telecommunications

Ivette Leon
Overview

11 New Accounting Branch Chiefs

Health Care & Insurance
Kevin Woody

Consumer Products
Will Choi

Natural Resources & Food
Karl Hiller
April Sifford
Overview

New Accounting Branch Chiefs

Manufacturing & Construction

*Nilima Shah*

Financial Services

*Joyce Sweeney*

Real Estate & Business Services

*Steven Jacobs*

*Cicely Luckey*
Overview

New Accounting Branch Chiefs

Emerging Growth Companies

Terence O’Brien
Electronics & Machinery

Angela Crane

Michele Gohlke
Corporation Finance

Financial Reporting and Disclosure Issues
Financial Reporting and Disclosure

- Accelerated Filer Proposal
- Statement of Cash Flows

Joel Levine
Accelerated Filer Proposal

Proposed Accelerated Filer Rule Amendment

• Computation of public float.
• New category of accelerated filer.
• Modification of accelerated deadlines.
• Ease ability to exit accelerated filer status.
• New cover page disclosures.
Accelerated Filer Proposal

Accelerated Filer – The issuer:

• Has been subject to Section 13(a) or 15(d) of Exchange Act for at least 12 calendar months.

• Has filed at least one annual report under Section 13(a) or 15(d) of the Exchange Act.

• Is not eligible to use forms 10-KSB and 10-QSB.

• Had an aggregate worldwide market value of its voting and non-voting common equity held by non-affiliates of $75 million or more, but less than $700 million, as of the last business day of its most recently completed second fiscal quarter.
## Accelerated Filer Proposal

<table>
<thead>
<tr>
<th></th>
<th>Form 10-K</th>
<th>Form 10-Q</th>
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<tbody>
<tr>
<td>Non-accelerated filer</td>
<td>90 days</td>
<td>45 days</td>
</tr>
<tr>
<td>Accelerated filer</td>
<td>75 days</td>
<td>40 days</td>
</tr>
<tr>
<td>Large accelerated filer</td>
<td>60 days</td>
<td>40 days</td>
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</tbody>
</table>
Accelerated Filer Proposal

Important Reminders

• Assess and reassess status only at year end.
• Public float is always determined as of the end of the most recently completed second quarter.
• A change in status will impact filing deadlines beginning with the Form 10-K for the year in which the assessment is made.
A **Large Accelerated Filer** or an **Accelerated Filer** whose public float drops below $25 million becomes a **non-accelerated filer**, beginning with the 10-K for the year in which the public float was determined.

A **Large Accelerated Filer** whose public float drops below $75 million, but not below $25 million, becomes an **Accelerated Filer**, beginning with the 10-K for the year in which the public float was determined.
Accelerated Filer Proposal

Cover page to Forms 10-K, 10-Q, and 20-F:

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer.

Large accelerated filer  ____
Accelerated filer  ____
Non-accelerated filer  ____
Accelerated Filer Proposal

Proposed Conforming Amendments

• Regulation S-X Rules 3-01, 3-09, and 3-12.

• Transition reports filed for change in fiscal year-end under Rules 13a-10 and 15d-10.

Proposed Rule Amendment Release and Comment Letters

• www.sec.gov.

• Regulatory Actions.
Statement of Cash Flows

- Increased focus by investors.
- Greater scrutiny in staff reviews.

- Discontinued operations.
- Dealer floor plan financing.
- Insurance claim settlement proceeds.
Statement of Cash Flows

Discontinued Operations

Footnote 10, FASB Statement 95
Separate disclosure of cash flows pertaining to discontinued operations reflected in the operating, investing, and financing categories is not required. An enterprise that nevertheless chooses to report separately operating cash flows of discontinued operations shall do so consistently for all periods affected.
Statement of Cash Flows

Key consideration is whether the presentation conforms with the basic disclosure requirement in FAS 95:

All cash flows must be reported as either an operating, investing, or financing activity.
Statement of Cash Flows

Examples:

- Combine cash flows from discontinued operations with cash flows from continuing operations within each category.

- Identify cash flows from discontinued operations within each category.

- Identify cash flows from discontinued operations for each category and present them separately.
Statement of Cash Flows

FAS 95 does not support:

- Aggregating operating, investing, and financing cash flows from discontinued operations into a single line item.

- Presenting operating, investing, and financing cash flows from discontinued operations all within the operating cash flows category.
Statement of Cash Flows

If using the indirect method under FAS 95 – reconcile from net income.

Paragraph 28
Entities that choose not to disclose operating cash receipts and payments by the direct method should adjust net income to reconcile it to net cash flow from operating activities (the indirect or reconciliation method).
Statement of Cash Flows

MD&A – Liquidity and Capital Resources:

- Describe how cash flows from Disc. Ops. are reported in the cash flows statement.
- Quantify cash flows from Disc. Ops. if not disclosed separately in the cash flows stmt.
- Describe how the absence of cash flows from Disc. Ops. are expected to affect future liquidity and capital resources. For example, effect on financing levels, terms, covenants, etc.
Statement of Cash Flows

Dealer purchases inventory through floor plan financing arrangement with subsidiary of supplier (seller financing):

- Finance subsidiary pays supplier (its parent).
- Finance subsidiary holds lien on inventory.
- Finance subsidiary will be repaid at future date by dealer (generally upon sale to dealer’s customer).
Statement of Cash Flows

Dealer reports purchase as increase to inventory and increase to trade loans within operating activities.

Repayment is reported as reduction to trade loans within operating activities.

- End result – net operating cash inflow for gross profit.
Statement of Cash Flows

Third-party financing arrangement:

- Finance entity is not affiliated with supplier.
- Report inventory purchase as operating activity cash outflow and loan as financing activity cash inflow.
- Reflects substance of financing transaction.
  - End result – net operating cash inflow for gross profit.
Statement of Cash Flows

Cash flows from insurance proceeds:

- Claim for property damage.
  - Is classification affected if proceeds are to be used to repay debt?

- Claim for business interruption.
  - Is classification affected if proceeds are to be used to buy equipment or settle litigation?
Paragraph 22c, FASB Statement 95
Classify as operating activity proceeds of insurance settlements except for those that are directly related to investing or financing activities, such as from destruction of a building.
Statement of Cash Flows

Report cash flows based on the nature of the insurance coverage (nature of loss).

- Not impacted by how you spend or plan to spend those proceeds.

Business interruption = operating activity.

Property damage or loss:

- PP&E owned or under capital lease = investing activity.
- PP&E under operating lease = operating activity.
- Inventory = operating activity.
Statement of Cash Flows

Discuss material settlements in MD&A:

• What you received.
• Why you received it.
• What you plan to do with it.
• Classification in cash flows statement.
• Impact on reported earnings.
Financial Reporting and Disclosure

- Loans Held for Sale
- Retained Interests in Securitized Loans
- Disclosures about Off-Balance Sheet Arrangements

Rachel Mincin
Loans Held for Sale

When should loans and trade receivables be recognized as held for investment instead of as held for sale?

- SFAS 65
  - Scope includes mortgage banking enterprises

- SOP 01-6
  - Scope includes finance companies and entities that do not consider themselves to be finance companies that engage in transactions that involve lending to or financing the activities of others
Loans Held for Sale

**Paragraph .08 of SOP 01-6**

- Loans and Trade Receivables are recognized as **not** held for sale when management has the intent and the ability to hold for the foreseeable future or until maturity.

- Once a decision has been made to sell loans not previously classified as held for sale, such loans should be transferred into the held for sale classification.
Loans Held for Sale

Loans and trade receivables should be accounted for as held for sale when:

- At origination or purchase management intends to sell the loan / trade receivable in an outright loan sale or in a securitization transaction, or

- Management decides to sell loans or receivables that were initially not classified as held for sale
Loans Held for Sale

**Impact on the financial statements**

- Loans HFS reported separately on the balance sheet at the lower of cost or fair value
- Accounting policy disclosure explaining:
  - How the registrant determines that a loan should initially be classified as HFS or later transferred to HFS
  - Method used to determine the lower of cost or fair value for loans / receivable HFS
Loans Held for Sale

**Impact on the statement of cash flows depends on:**

- Whether the loan or trade receivable results from the sale of the registrant’s goods or services
- Whether the loan or trade receivable was initially classified as held for sale or later transferred to held for sale
Loans Held for Sale – Cash Flows

When are loan / receivable cash flows recorded as operating?

- Paragraph 22 of SFAS 95 - cash receipts from the sale of short and long-term notes receivable from customers arising from sales of goods or services are operating.

- Paragraph 9 of SFAS 102 - cash receipts and payments resulting from acquisitions and sales of loans that are acquired specifically for resale and are carried at LOCOM should be classified as operating.
Loans Held for Sale – Cash Flows

When are loan / receivable cash flows recorded as investing?

- For manufacturing companies only loans that do not result from the sale of inventory to the company’s customers that are acquired with the intention of holding for the foreseeable future.

- For finance companies all loans that are acquired with the intention of holding for the foreseeable future.
Paragraph 9 of SFAS 102

“Cash receipts resulting from sales of loans that were not specifically acquired for resale shall be classified as investing cash flows. That is, if loans were acquired as investments, cash receipts from sales of those loans should be classified as investing cash inflows regardless of a change in the purpose of holding those loans.”
Retained Interests in Securitized Loans – Cash Flows

How should the exchange of loans / trade receivables for retained interests in securitized loans impact the statement of cash flows?

- No cash inflows or cash outflows should be reported
- May need to be disclosed as a non-cash investing activity
Retained Interests in Securitized Loans – Cash Flows

When should principal payments received on retained interests be recognized as operating cash inflows?

- Only when the retained interests are accounted for like trading securities instead of like AFS or HTM securities
- Paragraph 8 of SFAS 102 – cash payments received from securities and other assets should be classified as operating cash flows if those assets are acquired specifically for resale and carried at market value in a trading account
Retained Interests in Securitized Loans – Cash Flows

What is the impact on operating cash flows of acquiring loans for sale in securitization transactions that involve the receipt of subordinate retained interests that are accounted for like AFS securities?

- Negative operating cash flows
  - Loan acquisitions are operating cash outflows
  - Cash proceeds from sale are operating cash inflows
  - Cash flows from retained interest received as a result of securitization are investing cash inflows
Disclosures about Off-Balance Sheet Arrangements

Item 303 (a)(4)(ii) of Regulation S-K

- Requires disclosure about OBS arrangements in a separately-captioned section in MD&A
- Requires disclosure about OBS arrangements that management believes are reasonably likely to have a material effect
- Definition of OBS arrangement focuses on typical transactions in which risk of loss is not fully transparent
Disclosures about Off-Balance Sheet Arrangements

Definition of OBS Arrangement

- Guarantee contracts that are required to apply the measurement provisions of FIN 45
- Retained interest in assets transferred to an unconsolidated entity that serve as credit, liquidity or market risk support to that entity
- Instruments that meet the SFAS 133 definition of a derivative but qualify for the paragraph 11a. scope exception
- Material variable interests held in certain unconsolidated entities
Disclosures about Off-Balance Sheet Arrangements

Principal Based Disclosure Framework

- Information necessary for an understanding of the OBS arrangement and the material effects
  - Nature and business purpose of the arrangement
  - Importance of the arrangement
  - Financial impact of the arrangement and exposure to risk as a result of the arrangement
  - Known events, demands, commitments, trends or uncertainties that affect availability or benefit of the arrangement
Disclosures about Off-Balance Sheet Arrangements

Report Pursuant to Section 401(c) of SOX

- The extent of off-balance sheet arrangements including the use of SPEs
- Analyzed data from sample of 200 issuers, the 100 largest issuers and 100 issuers randomly selected
- Reviewed disclosures in 2003 Forms 10-K, including information provided in the Off-Balance Sheet section of MD&A
**Disclosures about Off-Balance Sheet Arrangements**

Data collected from the OBS arrangement section of MD&A

<table>
<thead>
<tr>
<th></th>
<th>Large Issuers</th>
<th>Random Issuers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Guarantees</td>
<td>39%</td>
<td>4%</td>
</tr>
<tr>
<td>Retained Interest</td>
<td>14%</td>
<td>0%</td>
</tr>
<tr>
<td>Equity-linked Derivatives</td>
<td>2%</td>
<td>1%</td>
</tr>
<tr>
<td>Variable Interest Entities</td>
<td>13%</td>
<td>1%</td>
</tr>
</tbody>
</table>
Disclosures about Off-Balance Sheet Arrangements

Observations

- A significant portion of issuers did not have a separately captioned OBS arrangement section in MD&A

- Rare for an issuer to discuss an equity linked derivative in the OBS arrangement section
Disclosures about Off-Balance Sheet Arrangements

Observations (continued)

- Some OBS arrangement section disclosures do not appear complete
  - Retained interest in securitized assets discussed in footnotes, but not OBS section
  - Involvement with VIEs discussed in other portions of MD&A
  - Guarantees included in the contractual obligations table, but not OBS section
Disclosures about Off-Balance Sheet Arrangements

Room for Improvement

- What was the business purpose for using the OBS entity?
  - Provide financing without having to recognize a liability

- What risks have been transferred and retained as a result of the arrangement?

- What are the factors that impact recognition of contingent obligations or losses related to OBS arrangements?
Disclosures about Off-Balance Sheet Arrangements

Best Practices

- Descriptions that specifically address your particular circumstances and operations
- Cross references that clearly identify specific information in the footnotes and integrate the substance of the footnotes into MD&A
- When applicable, disclosing that there are no material transactions that meet the Regulation S-K definition of an OBS arrangement
Financial Reporting and Disclosure

- Segments and Reporting Units
- DCP & ICFR – Reporting Issues
- Valuation Issues

Sondra Stokes
Financial Reporting and Disclosure

Identification of:

- Segments
- Reporting units
Segments

FAS 131 Objective (paragraph 3):

To provide information about the different types of business activities in which an entity engages and the different economic environments in which it operates to facilitate an understanding of the entity’s performance, its prospects for future cash flows and enable a reader to make more informed judgments about the entity as a whole.
Segments

How is the objective achieved?

Through the use of the management approach – by focusing on information used by an entity’s decision makers when they allocate resources and assess performance.
Segments

An operating segment is a component:
• That engages in business activities from which it may earn revenue and incur expense
• Whose operating results are regularly reviewed by the CODM in making decisions
• For which discrete financial information is available
Segments

Aggregation of operating segments

Should be consistent with the overall objective of FAS 131, possess similar economic characteristics and meet the following criteria:

◆ Similar products and services
◆ Similar production processes
◆ Similar type or class of customer
◆ Similar distribution methods
◆ Similar regulatory environment
Segments

Inappropriate aggregation of operating segments

- Aggregating segments that do not meet all of the aggregation criteria including economic similarity

- Aggregating quantitatively immaterial segments with a reportable segment with which it does not share a majority of the aggregation criteria
Segments

Why is it so important to properly identify the operating segments?

More than just a disclosure issue
Reporting Units

Required to assess goodwill for impairment under FAS 142 at the reporting unit level

An operating segment or one level below an operating segment (component)
Reporting Units

A component is a reporting unit if:

- It is a business
- Discrete financial information is available
- This information is regularly reviewed by segment management
Reporting Units

Aggregation of components in determining reporting units

- May be appropriate if the components have similar economic characteristic
- Not permitted across operating segments, despite the components sharing similar economic characteristics
Reporting Units

Disclosure:

- Reporting units identified
- How goodwill allocated
- Changes in
  - The number of reporting units
  - How goodwill was allocated
Reporting Units

Improper identification of operating segments means A likely misidentification of reporting units which can lead to Inappropriate calculations of goodwill impairment charges
Financial Reporting and Disclosure

Disclosure Controls and Procedures and Internal Control over Financial Reporting

Reporting Issues
DCP & ICFR – Reporting Issues

DCP – Disclosures currently apply to all registrants

ICFR - Disclosure applies to:

- Accelerated filers – FY ending on or after 11/15/04
- FPI’s who are accelerated filers – FY ending on or after 7/15/06
- Non accelerated filers (includes SB) – FY ending on or after 7/15/07
DCP & ICFR – Reporting Issues

Management must conclude that DCPs are either:

- Effective
- Ineffective

Not appropriate:
- “Effective except for”
- “Effective except as disclosed below”
- “Adequate”
Disclosure of material weaknesses

- Nature
- Impact on financial reporting and control environment
- Management’s remediation plan
- May also need MD&A disclosure

DCP & ICFR – Reporting Issues
If management does conclude that DCP are effective when material weaknesses in ICFR exist –

**Disclosure is critical:**

- Alternate factors relied upon
- Registrant specific – no boilerplate
- Clearly communicate how the conclusion was arrived at
- Tell the whole story
Management originally concluded that DCP and ICFR were effective. The registrant is now restating its financial statements due to errors.

What is the impact on management’s original conclusions on DCP and ICFR?
A material weakness in ICFR does not necessarily exist in every case of a restatement related to an error.

Look at:

- Why the restatement was necessary
- Whether the restatement resulted from a material weakness in controls
No specific requirement for the registrant to reassess ICFR to issue a revised management report BUT the registrant may elect to do so

- Registrant must review and may need to revise original disclosures under Item 308

Auditor may be required to issue a revised attestation report on the registrant’s ICFR as the audit report on the F/S and ICFR must have the same date
DCP & ICFR – Reporting Issues

Disclosure under Item 307 in the case of a restatement for errors where a material weakness has been identified

- Management must re-evaluate original conclusions on effectiveness of DCP in all amended reports
What should be disclosed with respect to ICFR in the Item 4.02 Form 8-K?
DCP & ICFR – Reporting Issues

Staff Statement on Management's Report on Internal Control Over Financial Reporting - Issued May 16, 2005
www.sec.gov/info/accountants/stafficreporting.pdf

www.sec.gov/info/accountants/controlfaq1004.htm
DCP & ICFR – Reporting Issues

Overall focus of reporting on ICFR - To identify items that could result in material errors to the financial statements

Disclosure is key
Financial Reporting and Disclosure

Valuation Issues

- Block discounts
- Warrants granted to non-employees
Valuation Issues

Block Discounts

We believe that available quoted market prices are evidence of the fair value of a financial instrument, and that block discounts are not in accordance with GAAP in determining fair value.
Valuation Issues

Block Discounts, continued

Use of quoted market prices

- FAS 107, paragraph 5
- FAS 107, paragraph 58
- FAS 115, paragraph 3a
Valuation Issues

Block Discounts, continued

Prohibition on block discounts

- FAS 107, paragraph 6
- FAS 115, Implementation Guide, Question 50
- EITF 98-5, Footnote 3

Paragraph 28 of 10/21/05 FASB Working Draft on Fair Value Measurements (SFAS No. 15X)
Valuation Issues

Warrants issued to non-employees

How they differ from employee share options –
- Typically do not contain transfer restrictions
- Normally subject to immediate exercise
Valuation Issues

Warrants issued to non-employees, continued

Footnote 7 of SAB 107

“If these features (i.e., nontransferability, nonhedgability and the truncation of the contractual term) were not present in a nonemployee share option arrangement, the use of an expected term assumption shorter than the contractual term would generally not be appropriate in estimating the fair value of the nonemployee share option.”
Valuation Issues

Warrants issued to non-employees, continued

If valued using Black-Scholes model
Use the contractual term in the calculation, not the expected term
SOS

(---..---)

Financial Reporting and Disclosure
Embedded Conversion Options and Freestanding Warrants

- Liabilities or Equity?

Todd E. Hardiman
Liability or Equity?

**Issue relates primarily to:**
- Convertible debt
- Convertible preferred stock
- Freestanding warrants to buy registrant’s stock

**Frequent resolution**
- Error correction
Liability or Equity?

Applicable Guidance Includes

- FASB
  - APB 14, APB 26, SFAS 133, SFAS 150
- EITF
  - EITF 96-19, EITF 98-5, EITF 00-4, EITF 00-6, EITF 00-19, EITF 00-27, EITF 01-6, EITF 03-6, EITF 05-1, EITF 05-2, EITF 05-4, EITF 05-7, EITF 05-8
- SEC
  - ASR 268, EITF D-98
Embedded Conversion Options

**Liability or Equity?**

**Embedded Conversion Options**

- Need to focus beyond intrinsic value
  - EITF 98-5 - Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios
  - EITF 00-27 – Application of Issue No. 98-5 to Certain Convertible Instruments

- Address fair value accounting under
  - SFAS 133 – Accounting for Derivative Instruments and Hedging Activities and
  - EITF 00-19 – Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, A Company’s Own Stock
Embedded Conversion Options
Accounting for Embedded Conversion Option

**Step 1 – SFAS 133**
- Evaluate Whether to Separate Embedded from Host (paragraph 12). If met, evaluate:
  - Scope Exception - paragraph 11a - go to EITF 00-19 if indexed to your own stock

**Step 2 – EITF 00-19 (Assume indexed to your own stock)**
- Evaluate whether embedded would be a liability or equity if it were freestanding
  - Liability – SFAS 133 scope exception NOT met. Separate embedded and account for it at fair value
  - Equity – SFAS 133 scope exception is met. Evaluate whether embedded has intrinsic value under EITFs 98-5 and 00-27

CAUTION: Highly Simplified. Also, Assumes SFAS 150 is Not Applicable
Embedded Conversion Options

Liability or Equity?

Red Flags in Registrant Disclosure

- Solely focused on intrinsic value accounting model in EITFs 98-5 and 00-27
  - No disclosure explaining why conversion option is not a derivative liability that must be fair valued under SFAS 133/EITF 00-19.

- Complex Financings
Embedded Conversion Options
Liability or Equity?

Restatements - Broad Observations

1. Improper Evaluation of SFAS 133, Paragraph 11a Exception for Fair Value Accounting
2. Result from Undisclosed Features
Embedded Conversion Options
Liability or Equity?

SFAS 133 – Accounting for Derivative Instruments and Hedging Activities

- **Paragraph 11a** - Notwithstanding the conditions in paragraphs 6-10, the reporting entity shall not consider the following contracts to be derivative instruments for purposes of this Statement:
  a. Contracts issued or held by the reporting entity that are both
     1. Indexed to its own stock and
     2. Classified in stockholders’ equity in its statement of financial position
Embedded Conversion Options
Evaluating SFAS 133, 11a scope exception

- EITF 00-19 – Evaluate whether embedded would be a liability or equity if it were freestanding
  - Liability – SFAS 133 scope exception NOT met. Separate embedded and account for it at fair value
  - Equity – SFAS 133 scope exception is met. Evaluate whether embedded has intrinsic value under EITFs 98-5 and 00-27
Evaluating SFAS 133, 11a scope exception

EITF 00-19, Paragraph 4 (in part) –

… The Task Force reached a consensus that for purposes of evaluating under Statement 133 whether an embedded derivative indexed to a company’s own stock would be classified in stockholders’ equity if freestanding, the requirements of paragraphs 12-32 of this Issue do not apply if the hybrid contract is a conventional convertible debt instrument in which the holder may only realize the value of the conversion option by exercising the option and receiving the entire proceeds in a fixed number of shares or the equivalent amount of cash (at the discretion of the issuer). …
EITF 00-19 “Conventional Convertible”

Assumptions:
- $1,000 convertible debt
- Convertible at any time at holder’s option
- Convertible into common stock
- Conversion price $10 per share

Analysis:
- *Entire proceeds* received in shares
- Number of shares *fixed* at 100

Conclusion: “Conventional”
Embedded Conversion Options
EITF 00-19 – “Conventional Convertible”

Example 1 - Conv. Price Reset Features

- Financial Statement Disclosure
  - $1,000 convertible debt
  - Convertible at any time at holder’s option
  - Convertible into common stock
  - Conversion price = $3

- Undisclosed Feature
  - If equity sale at less than $3 per share, conversion price resets to price in qualifying equity sale
Example 1- Reset Features (continued)

EITF 00-19, paragraph 4:

- **Conventional Convertible Debt Instrument** is a hybrid contract in which the holder may only realize the value of the conversion option by exercising the option and receiving the entire proceeds in a fixed number of shares or the equivalent amount of cash **(at the discretion of the issuer).**
Example 1 - Reset Features (continued)

Analysis

- “at the discretion of the issuer” = ability to choose form of settlement
- Reset required settlement in shares
- NOT Fixed as Number of Shares Dependent on Contingent Future Event (Equity Sale)

Conclusion – NOT “Conventional”
Other Conversion Price Reset Features

- Reset triggered by events within issuer’s control
  - Reset for Subsequent Equity Sale with Floor: Reset to subsequent equity sale price if less than conversion price, but in no event will conversion price be less than $2

- Reset triggered by events outside issuer’s control
  - Reset for failure to register: Conversion price reduced by 33% if failure to register by xx/xx/2005
  - Reset for failure to remain listed on NASDAQ
  - Reset for failure to maintain effectiveness

Result – NOT “Conventional” as number of shares dependent on contingent future event (not fixed)
Embedded Conversion Options
EITF 00-19 – “Conventional Convertible”

“Fixed Number of Shares” is NOT Dependent on Ability to Exercise

EITF 00-19, paragraph 4:

- Conventional Convertible Debt Instrument is a hybrid contract in which the holder may only realize the value of the conversion option by exercising the option and receiving the entire proceeds in a fixed number of shares or the equivalent amount of cash (at the discretion of the issuer).
Embedded Conversion Options
EITF 00-19 – “Conventional Convertible”

Example 2a - “Fixed Number of Shares” is NOT Dependent on Ability to Exercise

Assumptions:
- $1,000 convertible debt
- Convertible at holder’s option
  - After 1 year from issuance
  - After a secondary offering
- Convertible into common stock
- Conversion price $10 per share

Conclusion:
- “Conventional”
Embedded Conversion Options
EITF 00-19 – “Conventional Convertible”

Example 2b - “Fixed Number of Shares” is NOT Dependent on Ability to Exercise

Assumptions:
◆ $1,000 convertible debt
◆ Convertible at holder’s option
  ◆ After 1 year from issuance
  ◆ After a secondary offering
◆ Convertible into common stock
◆ Conversion price 80% of avg. trading price

Conclusion:
◆ NOT “Conventional”
Example 3 - “Entire Proceeds”

EITF 00-19, paragraph 4:

- **Conventional Convertible Debt Instrument** is a hybrid contract in which the holder may only realize the value of the conversion option by exercising the option and receiving the **entire** proceeds in a fixed number of shares or the equivalent amount of cash (at the discretion of the issuer).
Example 3 - “Entire Proceeds”

Assumptions:

- $1,000 convertible debt
- Convertible at holder’s option into c/s
- Conversion value = (FV of c/s on conversion date less conversion price) multiplied by number of shares received upon conversion
- Conversion price = $5 per share, but
  - pay cash = to face amount of debt and
  - then cash or shares for difference between cash paid and conversion value

Conclusion: NOT “Conventional”
Embedded Conversion Options
EITF 00-19 – Other Guidance

EITF 00-19, paragraphs 12 to 32

- Is it POSSIBLE that the conversion option would be settled for cash?
  - Yes - Classify as a liability
    - Does not meet the SFAS 133, paragraph 11a scope exception
    - Measure at fair value each reporting period
  - No – Classify as equity
    - Meets the SFAS 133, paragraph 11a scope exception
    - Do not separate from convertible instrument
    - Apply EITFs 98-5 and 00-27
Registration Rights Agreement

- Best efforts to register shares underlying conversion option by certain date
- Often requirement to maintain effectiveness of registration statement
- Liquidating damages if above provisions are not met
Embedded Conversion Options
EITF 00-19 – Other Guidance

EITF 05-4: The Effect of a Liquidating Damages Clause on a Freestanding Financial Instrument Subject to EITF 00-19

4 Views
1. Reg. Right = separate SFAS 133 derivative liability
   Combine Reg. Right with conversion option.
   Combined unit is a SFAS 133 derivative liability as:
2. Combined unit not indexed to own stock
3. Combined unit requires partial cash settlement
   OR
4. Combined unit is SFAS 133 derivative liability only
   if maximum penalty (Liq. Damages) exceeds difference between fair value of registered and unregistered share.
Example 1 – Net Cash Settlement

... then upon written demand made by the Holder, the Company will pay to the Holder, in lieu of delivering Common Stock, a sum equal to the closing price of the Company's Common Stock on the principal market or exchange upon which the Common Stock is listed for trading on the trading date immediately preceding the date notice is given by the Holder, less the Purchase Price, for each share of Common Stock designated in such notice from the Holder.
Example 2 – No Cap/Limit on Damages = Uneconomic Settlement Alternative

... the Company shall, for each such day, pay the Purchaser, as liquidated damages (“Liquidated Damages”) and not as a penalty, an amount equal to twenty-five percent (25%) of the Purchase Price per annum.
Example 2 - continued

Two Economic Choices:
1. Deliver Unregistered Shares and Pay Liquidating Damages Equal to 25% per year OR
2. Deliver Registered Shares
Example 2 – continued

**Economic Decision:**

- Are Liquidating Damages Limited to the Difference between the Fair Value of a Registered Share and an Unregistered Share?
  - Yes - Deliver unregistered shares and pay damages because:
    1. Fair value of unregistered shares plus damages is not greater than fair value of registered shares
    2. Ability to register shares is not within issuer’s control
  - No – Deliver registered shares
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Example 2 – continued

Analysis
• Liquidating Damages Accrue at 25% per year
• Liquidating Damages are NOT Explicitly Limited

Conclusions
• Damages Can Exceed Difference Between Fair Value of Registered and Unregistered shares
• Therefore Unregistered Shares is Uneconomic
• Ability to Register Shares is NOT within Issuer’s Control
• Assume Net Cash Settlement Even If No Net Cash Settlement Provision
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Example 2 – continued

Results
• Classify as a Liability under EITF 00-19
• Fails SFAS 133, Paragraph 11a Scope Exception
• Separate Embedded Derivative From Convertible Instrument and Account for It at Fair Value
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Example 3 – No Cap/Limit on Number of Shares to be Issued Upon Exercise

**EITF 00-19 requires:**

Sufficient Authorized and Unissued Shares to Settle the Conversion Option **Considering All Other Commitments** That May Require the Issuance of Stock During the Maximum Period the Derivative Contract could Remain Outstanding
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Sufficient Authorized and Unissued Shares

❖ Determine the Maximum Number of Shares that May Need to be Issued for Both
  ◆ Instrument Being Analyzed and
  ◆ “All Other Commitments”
    • Includes Employee Options and Other Embedded and Freestanding Instruments
Sufficient Authorized and Unissued Shares

- Lack of Cap or Limit in One Instrument May Cause Inability to Determine Maximum Number of Shares

- Result
  - Cannot Conclude Sufficient Authorized and Issued Shares Exist
  - Model Assumes Possibility of Net Cash Settlement
  - Classify as Liability
  - Fails SFAS 133 scope exception
  - Fair Value Accounting
Example 3 – No Cap/Limit on Number of Shares to be issued upon exercise may taint all 00-19 contracts

Assumptions:
- $20 million convertible debt
- Convertible at any time
- Conversion price is lower of $5 per share or 80% of daily avg. trading volume of c/s

Some Possible Outcomes upon Conversion:
If conv. price is ___ then issue ____ shares
- $5 per share = 4 million shares
- $1 per share = 20 million shares
- $0.01 per share = 2 billion shares
Embedded Conversion Options

How You Can Help:

- Review (Again) Terms in Indenture/Certificate and Related Agreements
- Identify and Disclose All Embedded Derivative Features
  - Conversion Option Reset Features
  - Other Embedded Derivatives
    - Redemption Features at Amounts in Excess of Par (e.g. 200% of par)
    - Interest Rate Floors that Double Rate of Return
  - Freestanding Warrants
- Consider POSSIBILITY to Net Cash Settle (Liquidating Damages)
- Explicitly State in Disclosure Why/Why Not Fair Value Accounting
Conclusion

Questions