| Question | Yes | No | Disclosure Requirement Met? | Referen |
|---|---|---|---|---|
| 1. Does the company have restrictions on its cash? | ____ | ____ | ____ | ____ |

## Disclosure Requirements

### Restricted Foreign Currency

Cash in one country may not be freely transferable to another country because exchange control regulations or other reasons. If the restricted funds held another country are significant, they should be segregated or disclosed in caption or note. If the restricted funds cannot be (or are not intended to be) us for general business purposes in the country where they are located, such fun should be classified as noncurrent assets in a classified balance sheet.

### Other Restricted Funds

Significant amounts of funds that are legally restricted in other ways also shou be segregated or disclosed in a caption or note. Funds held in escrow, procee from loans restricted for specified purposes, and reserve funds required un bond indentures are examples of such funds. If such funds are to be use acquire noncurrent assets or to liquidate long-term liabilities, they should b classified as long term in a classified balance sheet. However, if funds a restricted for the payment of interest, current maturities of debt or other curre liabilities, they should be classified as current.

Disclose the amount of cash and cash items restricted as to withdrawal o usage separately presented on the balance sheet (time deposits generally are n deemed restricted), the provisions of such restrictions, compensating balanc amounts, and arrangements.

*References: Regulation S-X, Rule 5-02-1 (Rule 5-02 is reflected in the FASB Accounting Standards Codification™ (ASC) at ASC 210, Balance Sheet (ASC 210-10-S99-1)); FRR 203; SAB Topic 6H (SAB Topic 6H is reflected in the ASC at ASC 210-10-S99-2)*

**Regulation S-X, Rule 5-02-1; FRR 203; SAB Topic 6H**

***Rule 5-02: Balance Sheets***

1. CASH AND CASH ITEMS.

Separate disclosure shall be made of the cash and cash items which are restricted as to withdrawal or usage. The provisions of any restrictions shall be described in a note to the financial statements. Restrictions may include legally restricted deposits held as compensating balances against short-term borrowing arrangements, contracts entered into with others, or company statements of intention with regard to particular deposits; however, time deposits and short-term certificates of deposit are not generally included in legally restricted deposits. In cases where compensating balance arrangements exist but are not agreements which legally restrict the use of cash amounts shown on the balance sheet, describe in the notes to the financial statements these arrangements and the amount involved, if determinable, for the most recent audited balance sheet required and for any subsequent unaudited balance sheet required in the notes to the financial statements. Compensating balances that are maintained under an agreement to assure future credit availability shall be disclosed in the notes to the financial statements along with the amount and terms of such agreement.

***FRR 203. Disclosure of Compensating Balances and Short-Term Borrowing Arrangements***

ASR 148

203.01. Reasons for Requirements

The management of liquidity is an important part of the financial management of a business entity. The maintenance of short-term borrowing capacity and the ability to obtain such funds at reasonable cost are major elements of such a management responsibility. If investors are to understand the financial policies of management, disclosure relative to these elements is necessary.

It is generally recognized in the financial community that one of the major elements in short-term financing policy is the maintenance of compensating balances supporting present and future credit from financial institutions. Such balances affect liquidity and the effective cost of borrowing. Nevertheless, disclosure of the essential details of such arrangements had been infrequent. When disclosure had occurred, the information supplied was generally insufficient to permit statement users to deal analytically with the subject. Lack of disclosure of amounts affecting liquidity such as compensating balances has been justified on the grounds that such arrangements were generally unwritten, informal and not subject to precise quantification. None of these reasons are sufficient to support a policy of nondisclosure of situations which are recognized to be both real and significant. They do, however, support the need for rule changes and disclosure guidelines so that reasonably uniform and understood standards for disclosure can be applied. They also indicate that disclosure must be based in many circumstances on reasonable estimates and that precision of measurement cannot be expected.

The interest paid for short-term borrowings is also of significance in appraising the financial policies and operating results of business entities. Changes in this rate over time may have a significant impact on profitability. The relationship of the rate paid at year end to short-term rates generally being charged at that date to corporate borrowers may be indicative of the future level of interest costs to be incurred by the corporation under varying conditions in the credit markets. In addition, information as to the magnitude of such borrowings during a fiscal period should further assist investors in determining the impact of changing credit conditions on business operations.

203.02 Compensating Balances

Rule 5-02-1 of Regulation S-X requires disclosure of compensating balances in order to avoid undisclosed commingling of such balances with other funds having different liquidity characteristics and bearing no determinable relationship to borrowing arrangements. Rule 5-02-1 also requires footnote disclosure distinguishing the amounts of such balances maintained under a formal agreement to assure future credit availability.

http://www.pbookshop.com

life), ASC 480-10-65-1 defers indefinitely the classification and measurement guidance in ASC 480.

2. Separately, ASC 480-10-65-1 also broadens the deferral of the measurement provisions by expanding it to include other types of mandatorily redeemable noncontrolling interests, provided the instruments were created before November 5, 2003. An example would be trust preferred securities issued by a consolidated trust. Entities affected by this expanded deferral must classify the instruments as debt and classify the returns to investors as interest where required by ASC 480 and make the disclosures required under ASC 480. However, they will measure the debt and interest in accordance with ASC 480-10-S99-3A.
3. The SEC staff has indicated its position that if a company issues preferred shares that are conditionally redeemable, the shares are not within the scope of ASC 480 because there is no unconditional obligation to redeem the shares by transferring assets at a specified or determinable date or upon an event certain to occur. If the uncertain event occurs, the condition is resolved, or the event becomes certain to occur, then the shares become mandatorily redeemable under ASC 480 and would require reclassification to a liability at fair value (with a corresponding reduction to equity).
4. The SEC staff has indicated its position regarding classification on the balance sheet for certain financial instruments (or host contracts) that meet the conditions for temporary equity classification under ASR 268 and ASC 480-10-S99-3A—which may include mandatorily redeemable stock. The SEC staff will not accept liability classification for financial instruments (or host contracts) that meet the conditions for temporary equity classification under ASR 268 and ASC 480-10-S99-3A. Consistent with SEC Regulation S-X, Articles 5-02, 7-03, and 9-03, these financial instruments should be classified on the balance sheet between captions for liabilities and shareholder's equity. As a consequence, the fair value option under ASC 825, *Financial Instruments* (ASC 825-10-15), may not be applied to any financial instrument (or host contract) that meets the conditions for temporary equity classification under ASR 268 and ASC 480-10-S99-3A.

While the measurement and/or classification guidance in ASC 480 is deferred as noted, the disclosure requirements are retained.

The effective date of ASC 480 remains unchanged for mandatorily redeemable shares issued by the parent company, written put options on a company's shares, forward purchase contracts for a company's shares, and contracts that require the issuance of shares in amounts unrelated to, or inversely related to, the value of the shares.

http://www.bookshop.com



*References: Regulation S-X, Rule 5-02-27 (Rule 5-02 is reflected in the ASC at ASC 210-10-S99-1); SAB Topic 3C (SAB Topic 3C is reflected in the ASC at ASC 480-10-S99-2); FRR 211 (FRR 211 is reflected in the ASC at ASC 480-10-S99-1); ASC 480-10-S99-03A*

**Regulation S-X, Rule 5-02-27; SAB Topic 3C; FRR 211; ASC 480-10-S99-3A**

***Rule 5-02: Balance Sheets***

27. PREFERRED STOCKS SUBJECT TO MANDATORY REDEMPTION REQUIREMENTS OR WHOSE REDEMPTION IS OUTSIDE THE CONTROL OF THE ISSUER.

(a) Include under this caption amounts applicable to any class of stock which has any of the following characteristics: (1) it is redeemable at a fixed or determinable price on a fixed or determinable date or dates, whether by operation of a sinking fund or otherwise; (2) it is redeemable at the option of the holder; or (3) it has conditions for redemption which are not solely within the control of the issuer, such as stocks which must be redeemed out of future earnings. Amounts attributable to preferred stock which is not redeemable or is redeemable solely at the option of the issuer shall be included under Rule 5-02-28 unless it meets one or more of the above criteria.

(b) State on the face of the balance sheet the title of each issue, the carrying amount, and redemption amount. (If there is more than one issue, these amounts may be aggregated on the face of the balance sheet and details concerning each issue may be presented in the note required by paragraph (c) below.) Show also the dollar amount of any shares subscribed but unissued, and show the deduction of subscriptions receivable therefrom. If the carrying value is different from the redemption amount, describe the accounting treatment for such difference in the note required by paragraph (c) below. Also state in this note or on the face of the balance sheet, for each issue, the number of shares authorized and the number of shares issued or outstanding, as appropriate. (See Rule 4-07.)

(c) State in a separate note captioned "Redeemable Preferred Stocks" (1) a general description of each issue, including its redemption features (e.g., sinking fund, at option of holders, out of future earnings) and the rights if any, of holders in the event of default, including the effect, if any, on junior securities in the event a required dividend, sinking fund, or other redemption payment(s) is not made; (2) the combined aggregate amount of redemption requirements for all issues each year for the five years following the date of the latest balance sheet; and (3) the changes in each issue for each period for which an income statement is required to be filed. (See also Rule 4-08(d).)

(d) Securities reported under this caption are not to be included under a general heading "stockholders' equity" or combined in a total with items described in captions 29, 30, or 31 which follow.

**Memorandum: Economic Evaluation of Alternative Market "Instrument Design"**

**TO:** Donald Nicolaisen, Chief Accountant

**FROM:** Chester S. Spatt, Cindy R. Alexander, M. Nimalendran, George Oldfield; Office of Economic Analysis

**DATE:** August 31, 2005

**RE:** Economic Evaluation of Alternative Market *instrument designs:* Toward a Market-Based Approach to Estimating the Fair Value of Employee Stock Options

At your request, we have reviewed various market-based approaches for estimating the grant-date fair value of employee stock options under FASB Statement of Financial Accounting Standards No. 123, Share-Based Payment ("Statement 123R"), which requires that companies recognize compensation paid in the form of employee stock options as a cost in their financial statements.

A market-based approach involves an instrument that will be traded among willing buyers and sellers, and the use of the instrument's market price as a reasonable estimate of the grant-date fair value of employee stock options.

The main conclusion of our analysis to date is that instruments that track the future flows of *net obligations* facing the company or *net receipts* by its employees under the option grant can yield reasonable estimates of fair value as defined in Statement 123R. Further, our analysis indicates that instruments that replicate the *terms and conditions* of employee stock options or other share-based compensation do not produce reasonable estimates of fair value.

These conclusions are relevant only to the design of the instrument. The suitability of any market-based approach to the estimation of fair value depends not only on an appropriate *instrument design*, but also on the presence of an appropriate *market pricing mechanism* and related *information plan* to ensure appropriate levels of competition and liquidity in the market for the instrument.

1. Background: Market-Based Approach and the Measurement Objective

The measurement objective under Statement 123R is the grant-date fair value of the company's obligation to its employees under the option grant, which is the cost to the company of making the grant, evaluated at the date of the grant. From an economic perspective, this can be viewed as the opportunity cost of the option grant to the company's shareholders.[1] The measurement objective is unaffected by the decision to use a market-based approach to valuation, rather than a model-based approach. Under the market-based approach, the company uses a market price as an alternative to the model-based estimate as its measure of fair value. The market price is the price at which a market instrument is traded between a willing buyer and seller. The price is obtained through a competitive market process.

A market-based approach must have three elements in order to generate a market price that is a reasonable estimate of the fair value of an employee stock option grant. In order to meet the objectives of Statement 123R, each element of the market-based approach must be consistent with the measurement of fair value:

- A market instrument that confers net payments on its holder that are equal in value to the fair value of all or part of the employee stock option grant.[2]



- A credible information plan that enables prospective buyers and sellers to price the instrument. For example, the plan should provide information about the exercise behavior of the employees in the grant. It should be easily accessible to all market participants to reduce the potential for adverse selection.
- A market pricing mechanism through which the instrument can be traded to generate a price. It should encourage participation in the market in order to promote competition among willing buyers and sellers.

Thus, the instrument design is just one of several elements of a market-based approach that must be consistent with the objective of fair value in order to produce a price equal to fair value.

We understand that no instruments were publicly available for estimating the fair value of employee stock options before the promulgation of Statement 123R. A variety of candidate instrument designs have come to our attention since the issuance of SAB 107 in March 2005, which provided guidance for companies to follow in using models to estimate fair value. This memo reflects our review of instrument designs to date.

Our conclusions about the potential for alternative instrument designs to generate reasonable estimates of fair value appear in the next section. In reaching these conclusions, we have assumed that other elements of the market-based approach are suitable to the estimation of fair value.

2. Alternative Approaches to Instrument Design

The candidate instruments for valuing employee stock option grants under Statement 123R have tended to fall into two categories, which we distinguish as the tracking approach and the terms and conditions approach. Of the two approaches, only the tracking approach appears likely to produce a reasonable estimate of the fair value of employee stock options, as we explain below.

A. Tracking Approaches

Under the tracking approaches, willing buyers and sellers trade rights to future payouts that are identical to the future flows of net receipts by employees or, equivalently, net obligations of the company under the grant. For the purpose of valuing an employee stock option grant, these two designs are consistent with measurement of fair value:

- An instrument that promises payments to its holder that are similar to the future intrinsic values realized by employees under the grant. This can be accomplished through the competitive sale by the company of an instrument with payments that track the intrinsic value realized by employees upon exercise of some or all of the applicable stock options.
- An instrument that assigns obligations to a third-party holder that are similar to the actual net obligations of the company to employees under the option grant. This can be accomplished by paying a qualified third-party to meet some or all of the company's obligations to employees under the option grant.

In each instance, the conditions of the instrument are designed to be binding.

From an economic perspective, the opportunity to trade a tracking instrument creates an incentive for buyers and sellers to devote resources to estimating the value of the instrument, and to reveal this information through the market price.

| Question | Yes | No | Disclosure Requirement Met? | Reference |
|---|---|---|---|---|
| 6. Was an operating company acquired in a leveraged buy-out transaction by a holding company with no other substantial operations? | ____ | ____ | ________ | ____ |

### *Disclosure Requirements*

A leveraged buy-out, for purposes of this disclosure section, represents a single highly leveraged transaction or a series of related and anticipated highly leveraged transactions that result in the acquisition by Newco of all previously outstanding common stock of Oldco; that is, there can be no remaining noncontrolling interest. This excludes transactions in which existing majority stockholders utilize a holding company to acquire all of the remaining shares of Oldco not previously owned.

When the combined company is the result of a leveraged buy-out as defined above, disclose the accounting policy and related rationale for determining the new basis.

*Reference: EITF Issue 88-16 (Issue 88-16 was not incorporated into the ASC the FASB; it has been considered by the FASB as historical in nature only.)*

---

**EITF Issue 88-16**

***EITF Issue 88-16: Basis in Leveraged Buyout Transactions***

Dates Discussed: June 2, 1988; July 14, 1988; August 25–26, 1988; October 6, 1988; January 12–13, 1989; February 23, 1989; May 18, 1989; June 29, 1989

ISSUE

A holding company (NEWCO) with no substantive operations acquires an operating company (OLDCO) in a leveraged buyout (LBO) transaction.

The issue is what basis should be used by NEWCO to value its interest in OLDCO; that is, whether the acquisition of shares of OLDCO establishes a new basis of accounting or whether predecessor basis, OLDCO book value, or some combination should be used.[6]

The underlying substance of the transaction must be evaluated to determine whether it constitutes:

1. A financial restructuring-recapitalization for which no change in accounting basis would be appropriate
2. A step acquisition for which a partial change in accounting basis would be appropriate

[6] Issues concerning recognizing a new basis in the financial statements of OLDCO or recording an owner's basis in the financial statements of OLDCO are outside the scope of this Issue.



3. A purchase by new controlling investors for which a partial or complete change in basis based on the fair value of the transaction would be appropriate.

SCOPE

To distinguish an LBO transaction within the scope of this Issue from other business combinations, the LBO should be effected in a single highly leveraged transaction or a series of related and anticipated highly leveraged transactions that result in the acquisition by NEWCO of all previously outstanding common stock of OLDCO; that is, there can be no remaining minority interest.[7] This Issue excludes LBO transactions in which existing majority stockholders utilize a holding company to acquire all of the shares of OLDCO not previously owned. Step acquisition accounting continues to be appropriate in such transactions.

DEFINITIONS

For purposes of this Issue, certain terms are defined as follows:

**Continuing Shareholder**

A NEWCO shareholder that owned a residual interest in OLDCO.

**Dilutive Securities**

Options, warrants, convertible securities, or any other financial instrument through which a person or entity may increase its voting or residual interest.

**Management**

Management comprises OLDCO employees or management that hold management positions and a residual interest in NEWCO. Regulation S-K, Item 401 should be considered when determining which individuals are included in management.

**Monetary Consideration**

Cash, debt, and debt-type instruments such as mandatorily redeemable preferred stock.

**Predecessor Basis**

A shareholder's basis in an interest in a business enterprise, that is, original cost of the investment in the business enterprise plus that shareholder's proportionate share of earnings or losses less dividends and any other distributions received by that shareholder from the business enterprise since the date of acquisition. A difference between a shareholder's cost of an investment and the amount of underlying equity in net assets of the business enterprise should be accounted for as if the business enterprise were a consolidated subsidiary for purposes of determining predecessor basis. The shareholder's proportionate equity in the book value of the business enterprise may be an acceptable substitute measure of predecessor basis, but only in circumstances for which it is impracticable to recompute predecessor basis. Predecessor basis in a stock option is the amount of cash or other tangible assets paid by the holder to obtain the option.

**Residual Interest**

An investor's proportionate share (expressed as a percentage and after conversion or exercise of dilutive securities) of the net assets of a business enterprise

[7] The concepts of Opinion 16 and consolidation require that 100 percent of the outstanding common stock of a target entity be acquired to potentially justify a 100 percent change in accounting basis.

http://www.pbookshop.com

The staff frequently reminds registrants that in periods subsequent to the initiation date that material changes and activity in the liability balances of each significant type of exit cost and involuntary employee termination benefits[4] (either as a result of expenditures or changes in/reversals of estimates or the fair value of the liability) should be disclosed in the footnotes to the interim and annual financial statements and discussed in MD&A. In the event a company recognized liabilities for exit costs and involuntary employee termination benefits relating to multiple exit plans, the staff believes presentation of separate information for each individual exit plan that has a material effect on the balance sheet, results of operations or cash flows generally is appropriate.

For material exit or involuntary employee termination costs related to an acquired business, the staff has requested disclosure in either MD&A or the financial statements of:

1. When the registrant began formulating exit plans for which accrual may be necessary,
2. The types and amounts of liabilities recognized for exit costs and involuntary employee termination benefits and included in the acquisition cost allocation, and
3. Any unresolved contingencies or purchase price allocation issues and the types of additional liabilities that may result in an adjustment of the acquisition cost allocation.

The staff has noted that the economic or other events that cause a registrant to consider and/or adopt an exit plan or that impair the carrying amount of assets generally occur over time. Accordingly, the staff believes that as those events and the resulting trends and uncertainties evolve, they often will meet the requirement for disclosure pursuant to the Commission's MD&A rules prior to the period in which the exit costs and liabilities are recorded pursuant to GAAP. Whether or not currently recognizable in the financial statements, material exit or involuntary termination costs that affect a known trend, demand, commitment, event, or uncertainty to management, should be disclosed in MD&A. The staff believes that MD&A should include discussion of the events and decisions which gave rise to the exit costs and exit plan, and the likely effects of management's plans on financial position, future operating results and liquidity unless it is determined that a material effect is not reasonably likely to occur. Registrants should identify the periods in which material cash outlays are anticipated and the expected source of their funding. Registrants should also discuss material revisions to exit plans, exit costs, or the timing of the plan's execution, including the nature and reasons for the revisions.

The staff believes that the expected effects on future earnings and cash flows resulting from the exit plan (for example, reduced depreciation, reduced employee expense, etc.) should be quantified and disclosed, along with the initial period in which those effects are expected to be realized. This includes whether the cost savings are expected to be offset by anticipated increases in other expenses or reduced revenues. This discussion should clearly identify the income statement line items to be impacted (for example, cost of sales; marketing; selling, general and administrative expenses; etc.). In later periods if actual savings anticipated by the exit plan are not achieved as expected or are achieved in periods other than as expected, MD&A should discuss that outcome, its reasons, and its likely effects on future operating results and liquidity.

[4] The staff would expect similar disclosures for employee termination benefits whether those costs have been recognized pursuant to FASB ASC Topic 420, FASB ASC Topic 712, *Compensation–Nonretirement Postemployment Benefits*, or FASB ASC Topic 715, *Compensation–Retirement Benefits*.



The staff often finds that, because of the discretionary nature of exit plans and the components thereof, presenting and analyzing material exit and involuntary termination charges in tabular form, with the related liability balances and activity (e.g., beginning balance, new charges, cash payments, other adjustments with explanations, and ending balances) from balance sheet date to balance sheet date, is necessary to explain fully the components and effects of significant restructuring charges. The staff believes that such a tabular analysis aids a financial statement user's ability to disaggregate the restructuring charge by income statement line item in which the costs would have otherwise been recognized, absent the restructuring plan (for example, cost of sales; selling, general, and administrative; etc.).

***Rule 5-04: What Schedules Are to Be Filed***

(a) Except as expressly provided otherwise in the applicable form:

(1) The schedules specified below in this Rule as Schedules II and III shall be filed as of the date of the most recent audited balance sheet for each person or group.

(2) Schedule II shall be filed for each period for which an audited income statement is required to be filed for each person or group.

(3) Schedules I and V shall be filed as of the date and for periods specified in the schedule.

(b) When information is required in schedules for both the registrant and the registrant and its subsidiaries consolidated it may be presented in the form of a single schedule: PROVIDED that items pertaining to the registrant are separately shown and that such single schedule affords a properly summarized presentation of the facts. If the information required by any schedule (including the notes thereto) may be shown in the related financial statement or in a note thereto without making such statement unclear or confusing, that procedure may be followed and the schedule omitted.

(c) The schedules shall be examined by the independent accountant if the related financial statements are so examined.

. . .

SCHEDULE II—VALUATION AND QUALIFYING ACCOUNTS.

The schedule prescribed by Rule 12-09 shall be filed in support of valuation and qualifying accounts included in each balance sheet but not included in Schedule VI. (See Rule 4-02.)

. . .

***ASC 420-10-50-1***

**50-1** All of the following information shall be disclosed in notes to financial statements that include the period in which an exit or disposal activity is initiated and any subsequent period until the activity is completed:

http://www.pbookshop.com

| Question | Yes | No | Disclosure Requirement Met? | Reference |
|---|---|---|---|---|
| 1. Did the company dispose of a component of a business (that qualifies as a discontinued operation) and retain material contingent liabilities? | ___ | ___ | ___ | ___ |

## Disclosure Requirements

Material contingent liabilities—such as product or environmental liabilities or litigation—that may remain with the company notwithstanding disposal of the underlying business should be:

- Identified in notes to the financial statements; and
- Discussed in terms of the reasonably likely range of possible loss pursuant to *FASB Accounting Standards Codification*™ (ASC) 450, *Contingencies*.

***Reference: SAB Topics 5Z4 5Z5 (SAB Topic 5Z5 is reflected in the ASC at ASC 205, Presentation of Financial Statements (ASC 205-20-S99-2))***

**SAB Topic 5Z4 and 5Z5**

***SAB Topic 5: Miscellaneous Accounting***

Z. ACCOUNTING AND DISCLOSURES REGARDING DISCONTINUED OPERATIONS.

4. Disposal of Operation with Significant Interest Retained

Facts: A Company disposes of its controlling interest in a component of an entity as defined by FASB ASC Master Glossary. The Company retains a minority voting interest directly in the component or it holds a minority voting interest in the buyer of the component. Controlling interest includes those controlling interests established through other means, such as variable interests. Because the Company's voting interest enables it to exert significant influence over the operating and financial policies of the investee, the Company is required by ASB ASC Subtopic 323-10, *Investments—Equity Method and Joint Ventures—Overall*, to account for its residual investment using the equity method.[54]

Question: May the historical operating results of the component and the gain or loss on the sale of the majority interest in the component be classified in the Company's statement of operations as "discontinued operations" pursuant to FASB ASC Subtopic 205-20, *Presentation of Financial Statements—Discontinued Operations*?

Interpretive Response: No. A condition necessary for discontinued operations reporting, as indicated in FASB ASC paragraph 205-20-45-1 is that an entity "not

[54] In some circumstances, the seller's continuing interest may be so great that divestiture accounting is inappropriate.



have any significant continuing involvement in the operations of the component after the disposal transaction." In these circumstances, the transaction should be accounted for as the disposal of a group of assets that is not a component of an entity and classified within continuing operations pursuant to FASB ASC paragraph 360-10-45-5 (Property, Plant, and Equipment Topic).[55]

5. Classification and Disclosure of Contingencies Relating to Discontinued Operations

Facts: A company disposed of a component of an entity in a previous accounting period. The Company received debt and/or equity securities of the buyer of the component or of the disposed component as consideration in the sale, but this financial interest is not sufficient to enable the Company to apply the equity method with respect to its investment in the buyer. The Company made certain warranties to the buyer with respect to the discontinued business, or remains liable under environmental or other laws with respect to certain facilities or operations transferred to the buyer. The disposition satisfied the criteria of FASB ASC Subtopic 205-20 for presentation as "discontinued operations." The Company estimated the fair value of the securities received in the transaction for purposes of calculating the gain or loss on disposal that was recognized in its financial statements. The results of discontinued operations prior to the date of disposal or classification as held for sale included provisions for the Company's existing obligations under environmental laws, product warranties, or other contingencies. The calculation of gain or loss on disposal included estimates of the Company's obligations arising as a direct result of its decision to dispose of the component, under its warranties to the buyer, and under environmental or other laws. In a period subsequent to the disposal date, the Company records a charge to income with respect to the securities because their fair value declined materially and the Company determined that the decline was other than temporary. The Company also records adjustments of its previously estimated liabilities arising under the warranties and under environmental or other laws.

Question 1: Should the write down of the carrying value of the securities and the adjustments of the contingent liabilities be classified in the current period's statement of operations within continuing operations or as an element of discontinued operations?

Interpretive Response: Adjustments of estimates of contingent liabilities or contingent assets that remain after disposal of a component of an entity or that arose pursuant to the terms of the disposal generally should be classified within discontinued operations.[56] However, the staff believes that changes in the carrying value of assets received as consideration in the disposal or of residual interests in the business should be classified within continuing operations.

FASB ASC paragraph 205-20-45-4 requires that "adjustments to amounts previously reported in discontinued operations that are directly related to the disposal of a component of an entity in a prior period shall be classified separately in the

[55] However, a plan of disposal that contemplates the transfer of assets to a limited-life entity created for the single purpose of liquidating the assets of a component of an entity would not necessitate classification within continuing operations solely because the registrant retains control or significant influence over the liquidating entity.

[56] Registrants are reminded that FASB ASC Topic 460, *Guarantees*, requires recognition and disclosure of certain guarantees which may impose accounting and disclosure requirements in addition to those discussed in this SAB Topic.

http://www.pbookshop.com

| Question | Yes | No | Disclosure Requirement Met? | Reference |
|---|---|---|---|---|
| 2. Is the company forming a one-bank holding company? | ____ | ____ | ____ | ____ |

## *Disclosure Requirements*

Provide the financial statements required in SAB Topic 1F.

*Reference: SAB Topic 1F*

### SAB Topic 1F

***SAB Topic 1: Financial Statements***

F. FINANCIAL STATEMENT REQUIREMENTS IN FILINGS INVOLVING THE FORMATION OF A ONE-BANK HOLDING COMPANY

Facts: Holding Company A is organized for the purpose of issuing common stock to acquire all of the common stock of Bank A. Under the plan of reorganization, each share of common stock of Bank A will be exchanged for one share of common stock of the holding company. The shares of the holding company to be issued in the transaction will be registered on Form S-4. The holding company will not engage in any operations prior to consummation of the reorganization, and its only significant asset after the transaction will be its investment in the bank. The bank has been furnishing its shareholders with an annual report that includes financial statements that comply with GAAP.

Item 14 of Schedule 14A of the proxy rules provides that financial statements generally are not necessary in proxy material relating only to changes in legal organization (such as reorganizations involving the issuer and one or more of its totally held subsidiaries).

Question 1: Must the financial statements and the information required by Securities Act Industry Guide ("Guide 3")[2] for Bank A be included in the initial registration statement on Form S-4?

Interpretive Response: No, provided that certain conditions are met. The staff will not take exception to the omission of financial statements and Guide 3 information in the initial registration statement on Form S-4 if all of the following conditions are met:

- There are no anticipated changes in the shareholders' relative equity ownership interest in the underlying bank assets, except for redemption of no more than a nominal number of shares of unaffiliated persons who dissent;
- In the aggregate, only nominal borrowings are to be incurred for such purposes as organizing the holding company, to pay nonaffiliated persons who dissent, or to meet minimum capital requirements;

[2] Item 801 of Regulation S-K.



- There are no new classes of stock authorized other than those corresponding to the stock of Bank A immediately prior to the reorganization;
- There are no plans or arrangements to issue any additional shares to acquire any business other than Bank A; and
- There has been no material adverse change in the financial condition of the bank since the latest fiscal year-end included in the annual report to shareholders.

If at the time of filing the S-4, a letter is furnished to the staff stating that all of these conditions are met, it will not be necessary to request the Division of Corporation Finance to waive the financial statement or Guide 3 requirements of Form S-4.

Although the financial statements may be omitted, the filing should include a section captioned, "Financial Statements," which states either that an annual report containing financial statements for at least the latest fiscal year prepared in conformity with GAAP was previously furnished to shareholders or is being delivered with the prospectus. If financial statements have been previously furnished, it should be indicated that an additional copy of such report for the latest fiscal year will be furnished promptly upon request without charge to shareholders. The name and address of the person to whom the request should be made should be provided. One copy of such annual report should be furnished supplementally with the initial filing for purposes of staff review.

If any nominal amounts are to be borrowed in connection with the formation of the holding company, a statement of capitalization should be included in the filing which shows Bank A on an historical basis, the pro forma adjustments, and the holding company on a pro forma basis. A note should also explain the pro forma effect, in total and per share, which the borrowings would have had on net income for the latest fiscal year if the transaction had occurred at the beginning of the period.

Question 2: Are the financial statements of Bank A required to be audited for purposes of the initial Form S-4 or the subsequent Form 10-K report?

Interpretive Response: The staff will not insist that the financial statements in the annual report to shareholders used to satisfy the requirement of the initial Form S-4 be audited.

The consolidated financial statements of the holding company to be included in the registrant's initial report on Form 10-K should comply with the applicable financial statement requirements in Regulation S-X at the time such annual report is filed. However, the regulations also provide that the staff may allow one or more of the required statements to be unaudited where it is consistent with the protection of investors.[3] Accordingly, the policy of the Division of Corporation Finance is as follows:

- The registrant should file audited balance sheets as of the two most recent fiscal years and audited statements of income and cash flows for each of the three latest fiscal years, with appropriate footnotes and schedules as required by Regulation S-X unless the financial statements have not previously been audited for the periods required to be filed. In such cases, the Division will not object if the financial statements in the

[3] Rule 3-13 of Regulation S-X.

http://www.pbookshop.com

(vii) Possible undeveloped reserves (optional).

INSTRUCTION 1 TO PARAGRAPH (a)(2).

Disclose updated reserves tables as of the close of each fiscal year.

INSTRUCTION 2 TO PARAGRAPH (a)(2).

The registrant is permitted, but not required, to disclose probable or possible reserves pursuant to paragraphs (a)(2)(iv) through (a)(2)(vii) of this Item.

INSTRUCTION 3 TO PARAGRAPH (a)(2).

If the registrant discloses amounts of a product in barrels of oil equivalent, disclose the basis for such equivalency.

INSTRUCTION 4 TO PARAGRAPH (a)(2).

A registrant need not provide disclosure of the reserves in a country containing 15% or more of the registrant's proved reserves if that country's government prohibits disclosure of reserves in that country. In addition, a registrant need not provide disclosure of the reserves in a country containing 15% or more of the registrant's proved reserves if that country's government prohibits disclosure in a particular field and disclosure of reserves in that country would have the effect of disclosing reserves in particular fields.

(3) Reported total reserves shall be simple arithmetic sums of all estimates for individual properties or fields within each reserves category. When probabilistic methods are used, reserves should not be aggregated probabilistically beyond the field or property level; instead, they should be aggregated by simple arithmetic summation.

(4) Disclose separately material reserves of the following product types:

(i) Oil;

(ii) Natural gas;

(iii) Synthetic oil;

(iv) Synthetic gas and;

(v) Sales products of other non-renewable natural resources that are intended to be upgraded into synthetic oil and gas.

(5) If the registrant discloses probable or possible reserves, discuss the uncertainty related to such reserves estimates.

(6) If the registrant has not previously disclosed reserves estimates in a filing with the Commission or is disclosing material additions to its reserves estimates, the registrant shall provide a general discussion of the technologies used to establish the appropriate level of certainty for reserves estimates from material properties included in the total reserves disclosed. The particular properties do not need to be identified.

http://www.pbookshop.com



(7) PREPARATION OF RESERVES ESTIMATES OR RESERVES AUDIT. Disclose and describe the internal controls the registrant uses in its reserves estimation effort. In addition, disclose the qualifications of the technical person primarily responsible for overseeing the preparation of the reserves estimates and, if the registrant represents that a third party conducted a reserves audit, disclose the qualifications of the technical person primarily responsible for overseeing such reserves audit.

(8) THIRD PARTY REPORTS. If the registrant represents that a third party prepared, or conducted a reserves audit of, the registrant's reserves estimates, or any estimated valuation thereof, or conducted a process review, the registrant shall file a report of the third party as an exhibit to the relevant registration statement or other Commission filing. If the report relates to the preparation of, or a reserves audit of, the registrant's reserves estimates, it must include the following disclosure, if applicable to the type of filing:

(i) The purpose for which the report was prepared and for whom it was prepared;

(ii) The effective date of the report and the date on which the report was completed;

(iii) The proportion of the registrant's total reserves covered by the report and the geographic area in which the covered reserves are located;

(iv) The assumptions, data, methods, and procedures used, including the percentage of the registrant's total reserves reviewed in connection with the preparation of the report, and a statement that such assumptions, data, methods, and procedures are appropriate for the purpose served by the report;

(v) A discussion of primary economic assumptions;

(vi) A discussion of the possible effects of regulation on the ability of the registrant to recover the estimated reserves;

(vii) A discussion regarding the inherent uncertainties of reserves estimates;

(viii) A statement that the third party has used all methods and procedures as it considered necessary under the circumstances to prepare the report;

(ix) A brief summary of the third party's conclusions with respect to the reserves estimates; and

(x) The signature of the third party.

(9) For purposes of this Item 1202, the term reserves audit means the process of reviewing certain of the pertinent facts interpreted and assumptions underlying a reserves estimate prepared by another party and the rendering of an opinion

| Question | Yes | No | Disclosure Requirement Met? | Reference |
|---|---|---|---|---|
| 8. Did the company have capitalized exploratory drilling costs? | ____ | ____ | ____ | ____ |

## Disclosure Requirements

The SEC staff commented that it has observed instances where the accounting for exploratory drilling costs has not corresponded to the explicit requirements in ASC 932, *Extractive Activities—Oil and Gas* (ASC 932-360-35-13 and ASC 932-360-35-16 through 35-20) (FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, paragraphs 31 to 34). The concern expressed by the SEC staff is documented in a letter dated February 11, 2005; however, that letter was issued before the issuance of FASB Staff Position (FSP) FAS 19-1, "Accounting for Suspended Well Costs," which has been incorporated into the Codification by the FASB in ASC 932-235-50-16. Registrants should consider the guidance in the February 11, 2005 letter, but recognize that it was authored shortly after the Exposure Draft of the FSP was issued and has not been updated for the final guidance.

***References:** SEC Sample Letter, February 11, 2005 (see Question 7 above); ASC 932-235-50-1B (see Question 4 above); ASC 932-360-35-13; ASC 932-360-35-16 through 35-20; Compliance and Disclosure Interpretations: Oil and Gas Rules (see Question 1 above)*

http://www.pbookshop.com

---

**ASC 932-360-35-13; ASC 932-360-35-16 through 35-20**

***ASC 932-360-35-13***

COMPLETED EXPLORATORY WELLS

**35-13** If the sufficient progress criteria (see paragraphs 932-360-35-18 through 35-20)is not met, or if an entity obtains information that raises substantial doubt about the economic or operational viability of the project, the **exploratory well** or exploratory-type stratigraphic well shall be assumed to be impaired and its costs, net of any salvage value, shall be charged to expense. Further, an entity shall not continue to capitalize exploratory well costs on the chance that either of the following might occur:

a. Current market conditions will change (for example, an increase in the market price of oil or gas).

b. Technology will be developed to make the development of the project economically and operationally viable.

***ASC 932-360-35-16 through 35-20***

RECLASSIFICATION OF COMPLETED EXPLORATORY WELLS

**35-16** As specified in paragraph 932-360-25-10, the costs of drilling an exploratory well or an exploratory-type stratigraphic well shall be capitalized as part of the entity's **uncompleted wells, equipment, and facilities** pending the determination of whether the well has found proved reserves.



**35-17** If proved reserves are found, the capitalized costs of drilling the well shall be reclassified as part of the costs of the entity's wells and related equipment and facilities at that time (even though the well may not be completed as a producing well). If proved reserves are not found, the capitalized costs of drilling the well shall be charged to expense.

SUFFICIENT PROGRESS ASSESSMENT

**35-18** An exploratory well or an exploratory-type stratigraphic well may be determined to have found oil and gas reserves, but those reserves cannot be classified as proved when drilling is completed. In those cases, the capitalized drilling costs shall continue to be capitalized if the well has found a sufficient quantity of reserves to justify its completion as a producing well and the entity is making sufficient progress assessing the reserves and the economic and operating viability of the project. Note that an entity is not required to complete the exploratory or exploratory-type stratigraphic well as a producing well. For purposes of determining whether capitalized drilling costs shall continue to be capitalized pending the determination of proved reserves, a project may include more than one exploratory well or exploratory-type stratigraphic well if the reserves are intended to be extracted in a single, integrated producing operation (for example, the producing wells will operate with shared infrastructure).

**35-19** All relevant facts and circumstances shall be evaluated when determining whether an entity is making sufficient progress on assessing the reserves and the economic and operating viability of the project. The following are some indicators, among others, that an entity is making sufficient progress (see the following paragraph). No single indicator is determinative. An entity shall evaluate indicators in conjunction with all other relevant facts and circumstances. These indicators include:

a. Commitment of project personnel who are at the appropriate levels and who have the appropriate skills

b. Costs that are being incurred to assess the reserves and their potential development

c. An assessment process covering the economic, legal, political, and environmental aspects of the potential development is in progress

d. Existence (or active negotiations) of sales contracts with customers for the oil and gas

e. Existence (or active negotiations) of agreements with governments, lenders, and venture partners

f. Outstanding requests for proposals for development of any required facilities

g. Existence of firm plans, established timetables, or contractual commitments, which may include seismic testing and drilling of additional exploratory wells

h. Progress that is being made on contractual arrangements that will permit future development

i. Identification of existing transportation and other infrastructure that is or will be available for the project (subject to negotiations for use).

State separately in the income statement any material amount included in all other operating expenses.

8. INCOME OR LOSS BEFORE INCOME TAX EXPENSE AND APPROPRIATE ITEMS BELOW.

(Item has no text)

9. INCOME TAX EXPENSE.

Include under this caption only taxes based on income. (See Rule 4-08(g).)

10. EQUITY IN EARNINGS OF UNCONSOLIDATED SUBSIDIARIES AND 50-PERCENT-OR-LESS OWNED PERSONS.

State, parenthetically or in a note, the amount of dividends received from such persons. If justified by the circumstances, this item may be presented in a different position and a different manner. (See Rule 4-01 (a).)

11. INCOME OR LOSS FROM CONTINUING OPERATIONS.

(Item has no text)

12. DISCONTINUED OPERATIONS.

(Item has no text)

13. INCOME OR LOSS BEFORE EXTRAORDINARY ITEMS AND CUMULATIVE EFFECTS OF CHANGES IN ACCOUNTING PRINCIPLES.

(Item has no text)

14. EXTRAORDINARY ITEMS, LESS APPLICABLE TAX.

(Item has no text)

15. CUMULATIVE EFFECTS OF CHANGES IN ACCOUNTING PRINCIPLES.

(Item has no text)

16. NET INCOME OR LOSS.

(Item has no text)

17. NET INCOME ATTRIBUTABLE TO NONCONTROLLING INTEREST.

18. NET INCOME ATTRIBUTABLE TO CONTROLLING INTEREST.

19. EARNINGS PER SHARE DATA.

(Item has no text)

WHAT SCHEDULES ARE TO BE FILED

RULE 7-05. (a) Except as expressly provided otherwise in the applicable form:

(1) The schedule specified below in this section as Schedule I shall be as of the date of the most recent audited balance sheet for each person or group.

(2) The schedules specified below in this section as Schedule IV and V shall be filed for each period for which an audited income statement is required to be filed for each person or group.

(3) Schedules II, III, and VI shall be filed as of the date and for periods specified in the schedule.

(b) When information is required in schedules for both the registrant and the registrant and its subsidiaries consolidated it may be presented in the form of a single schedule: PROVIDED, That items pertaining to the registrant are shown separately and that such single schedule affords a properly summarized presentation of the facts. If the information required by any schedule (including the notes thereto) may be shown in the related financial statement or in a note thereto without making such statement unclear or confusing, that procedure may be followed and the schedule omitted.

(c) The schedules shall be examined by the independent accountant.



SCHEDULE I. SUMMARY OF INVESTMENTS—OTHER THAN INVESTMENTS IN RELATED PARTIES.

The schedule prescribed by Rule 12-15 shall be filed in support of caption 1 of the most recent audited balance sheet.

SCHEDULE II. CONDENSED FINANCIAL INFORMATION OF REGISTRANT.

The schedule prescribed by Rule 12-04 shall be filed when the restricted net assets (Rule 4-08(e)(3)) of consolidated subsidiaries exceed 25 percent of consolidated net assets as of the end of the most recently completed fiscal year. For purposes of the above test, restricted net assets of consolidated subsidiaries shall mean that amount of the registrant's proportionate share of net assets of consolidated subsidiaries (after intercompany eliminations) which as of the end of the most recent fiscal year may not be transferred to the parent company by subsidiaries in the form of loans, advances or cash dividends without the consent of a third party (i.e., lender, regulatory agency, foreign government, etc.). Where restrictions on the amount of funds which may be loaned or advanced differ from the amount restricted as to transfer in the form of cash dividends, the amount least restrictive to the subsidiary shall be used. Redeemable preferred stocks (Rule 7-03-20) and noncontrolling interests shall be deducted in computing net assets for purposes of this test.

SCHEDULE III. SUPPLEMENTARY INSURANCE INFORMATION.

The schedule prescribed by Rule 12-16 shall be filed giving segment detail in support of various balance sheet and income statement captions. The required balance sheet information shall be presented as of the date of each audited balance sheet filed, and the income statement information shall be presented for each period for which an audited income statement is required to be filed, for each person or group.

SCHEDULE IV. REINSURANCE.

The schedule prescribed by Rule 12-17 shall be filed for reinsurance ceded and assumed.

SCHEDULES V. VALUATION AND QUALIFYING ACCOUNTS.

The schedule prescribed by Rule 12-09 shall be filed in support of valuation and qualifying accounts included in the balance sheet. (See Rule 4-02.)

SCHEDULE VI. SUPPLEMENTAL INFORMATION CONCERNING PROPERTY-CASUALTY INSURANCE OPERATIONS.

The information required by Rule 12-18 shall be presented as of the same dates and for the same periods for which the information is reflected in the audited consolidated financial statements required by Rules 3-01 and 3-02. The schedule may be omitted if reserves for unpaid property-casualty claims and claim adjustment expenses of the registrant and its consolidated subsidiaries, its unconsolidated subsidiaries and its 50-percent-or-less-owned equity basis investees did not in the aggregate, exceed one-half of common stockholders' equity of

http://www.pbookshop.com

(d) Disclosed in this report any change in the issuer's internal control over financial reporting that occurred during the period covered by the annual report that has materially affected, or is reasonably likely to materially affect, the issuer's internal control over financial reporting; and

5. The issuer's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the issuer's auditors and the audit committee of the issuer's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the issuer's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal control over financial reporting.

Date: ______________

______________________

[Signature]

[Title]

(2) (i) Provide the certifications required by Rule 13a-14(b) (17 CFR 240.13a-14(b)) or Rule 15d-14(b) (17 CFR 240.15d-14(b)) and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. 1350) as an exhibit to this report.

(ii) A certification furnished pursuant to Rule 13a-14(b) (17 CFR 240.13a-14(b)) or Rule 15d-14(b) (17 CFR 240.15d-14(b)) and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. 1350) will not be deemed "filed" for purposes of Section 18 of the Exchange Act [15 U.S.C. 78r], or otherwise subject to the liability of that section. Such certification will not be deemed to be incorporated by reference into any filing under the Securities Act or the Exchange Act, except to the extent that the issuer specifically incorporates it by reference.

(b) Disclosure Controls and Procedures. Where the Form is being used as an annual report filed under Section 13(a) or 15(d) of the Exchange Act, disclose the conclusions of the issuer's principal executive and principal financial officers, or persons performing similar functions, regarding the effectiveness of the issuer's disclosure controls and procedures (as defined in 17 CFR 240.13a-15(e) or 240.15d-15(e)) as of the end of the period covered by the report, based on the evaluation of these controls and procedures required by paragraph (b) of 17 CFR 240.13a-15 or 240.15d-15.

(c) Management's annual report on internal control over financial reporting. Where the Form is being used as an annual report filed under Section 13(a) or 15(d) of the Exchange Act, provide a report of management on the issuer's internal control over financial reporting (as defined in 17 CFR 240.13a-15(f) or 240.15d-15(f)) that contains:

http://www.pbookshop.com



(1) A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the issuer;

(2) A statement identifying the framework used by management to evaluate the effectiveness of the issuer's internal control over financial reporting as required by paragraph (c) of 17 CFR 240.13a-15 or 240.15d-15;

(3) Management's assessment of the effectiveness of the issuer's internal control over financial reporting as of the end of the issuer's most recent fiscal year, including a statement as to whether or not internal control over financial reporting is effective. This discussion must include disclosure of any material weakness in the issuer's internal control over financial reporting identified by management. Management is not permitted to conclude that the issuer's internal control over financial reporting is effective if there are one or more material weaknesses in the issuer's internal control over financial reporting; and

(4) If an issuer is an accelerated filer or a large accelerated filer (as defined in 17 CFR 240.12b-2), or otherwise includes in its annual report a registered public accounting firm's attestation report on internal control over financial reporting, a statement that the registered public accounting firm that audited the financial statements included in the annual report containing the disclosure required by this Item has issued an attestation report on management's assessment of the issuer's internal control over financial reporting.

(d) Attestation report of the registered public accounting firm. If an issuer is an accelerated filer or a large accelerated filer (as defined in § 240.12b-2 of this chapter), and where the Form is being used as an annual report filed under Section 13(a) or 15(d) of the Exchange Act, provide the registered public accounting firm's attestation report on management's assessment of the issuer's internal control over financial reporting in the issuer's annual report containing the disclosure required by this Item.

(e) Changes in internal control over financial reporting. Disclose any change in the issuer's internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of 17 CFR 240.13a-15 or 240.15d-15 that occurred during the period covered by the annual report that has materially affected, or is reasonably likely to materially affect, the issuer's internal control over financial reporting.

INSTRUCTIONS TO PARAGRAPHS (B), (C), (D) AND (E) OF GENERAL INSTRUCTION B.6.

1. An issuer need not comply with paragraphs (c) and (d) of this Instruction until it either had been required to file an annual report pursuant to the requirements of section 13(a) or 15(d) of the Exchange Act (15 U.S.C. 78m(a) or 78o(d)) for the prior fiscal year or had filed an annual report with

cial targets; therefore, management and the auditor may also need to evaluate whether any changes to the fraud risk assessment are needed.

If management or the auditor determines that new financial reporting risks exist, or that its assessment of existing risks has changed, including the risk of fraud, then they should consider how this impacts management's assessment or the audit of internal control over financial reporting.

Regarding management's assessment, management has to determine whether it has the proper controls in operation to address the changes in financial reporting risks. For example, if impairment of long-lived assets is now considered higher risk because a triggering event requires management to determine whether an impairment charge should be recorded, management may need to evaluate whether they have the proper controls in place, including controls related to the development of significant estimates and assumptions, to mitigate this risk. Also, the design of a company's internal control over financial reporting may be impacted through restructuring activities and/or employee terminations as a result of the current economic environment. As such, companies may need to consider the impact of these changes on its control structure, which may include whether certain controls no longer exist, whether new controls have been designed and placed in operation, or whether personnel now responsible for operating or monitoring the controls contain the level of expertise necessary to ensure the controls operate as intended. If changes to the fraud risk assessment occur, a company may need to evaluate whether its control structure is sufficient to mitigate the associated risks, including evaluating entity level controls and controls over management override. Furthermore, if the risk of material misstatement increases related to certain accounts, disclosures, or assertions, or risk related to the operation of controls increases, management may need to obtain more evidence regarding the effectiveness of those controls.

Regarding the audit of internal control over financial reporting, changes in financial reporting risks may impact the nature, timing, and extent of testing the design and operating effectiveness of a company's internal control over financial reporting.

Management may also need to consider whether and how the current market conditions impact its disclosure controls and procedures. A company's disclosure controls and procedures are designed to ensure that information required to be disclosed is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms. In today's economic environment, changes to existing disclosures or incremental disclosures may be necessary to comply with the disclosure requirements in areas such as risks and uncertainties, liquidity, and credit risks, just to name a few. As such, management may need to determine whether it has the proper procedures in place to gather the necessary information for these disclosures. For example, if the liquidity risk of certain operating divisions has increased, corporate management may need to ensure it is requesting and receiving the proper information to ensure the disclosures are adequate.

When considering the impact that today's economic environment may have on a company's disclosure controls and procedures and internal control over financial reporting, the best approach is to consider the impact together with the accounting issues and not as a separate process. An integrated approach may help in preventing and detecting material misstatements of the financial statements.

http://www.pbookshop.com



Disclosures of Internal Control over Financial Reporting

Next, I wanted to discuss some general observations regarding the disclosures of internal control over financial reporting. The SEC staff continues to review these disclosures and encourages companies to provide the most meaningful information to investors. I will discuss some observations regarding material weakness disclosures and other unique situations regarding disclosures of internal control over financial reporting.

The goal underlying material weakness disclosures is to go beyond describing the mere existence of a material weakness but to allow for investors to understand the cause of the control deficiency and to assess its potential impact. In disclosing material weaknesses, management might consider the following questions:

- Does the disclosure adequately describe the control deficiency? Companies should consider providing disclosures that allow investors to understand the control deficiency and the actual cause of the control deficiency. The SEC staff has observed in certain situations, a material weakness resulted from an adjustment to the financial statements but the material weakness identified is often a description of the financial statement adjustment rather than the control deficiency that resulted in the material weakness.
- Does the disclosure allow users to determine whether the deficiency has a pervasive impact on internal control over financial reporting? Material weakness disclosures that distinguish ones which have a pervasive impact on internal control over financial reporting may be more meaningful to investors. The SEC staff has observed in certain situations that the material weaknesses described are limited to specific areas where an error has been discovered. In these situations, a question may arise as to whether the material weakness impacts other areas of the financial statements.

Other questions to consider when evaluating whether the most meaningful disclosures regarding internal control over financial reporting are being provided to investors consist of the following:

- Have adequate disclosures been included when a company restates previously issued financial statements to correct a material misstatement? Management is not required to reassess or revise its conclusions related to the effectiveness of internal control over financial reporting but management should consider whether its original disclosures are still appropriate and should modify or supplement its original disclosure to include any other material information that is necessary for such disclosures not to be misleading in light of the restatement. When management restates previously issued financial statements to correct a material misstatement, it may have concluded a material weakness does not exist, existed but has since been remediated, or still exists as of the current year-end. Regardless of the conclusion, investors would generally benefit from information regarding management's judgment in this area.
- Have all material weaknesses been disclosed? Items 308(a) and 308T(a) of Regulation S-K require management to disclose any material weaknesses in internal control over financial reporting that have been identified by management. The SEC staff has observed in certain situations that the disclosures of management's remediation effort, suggest that all

## CHANGE IN SHELL COMPANY STATUS—ITEM 5.06

| Question | Yes | No | Disclosure Requirement Met? | Reference |
|---|---|---|---|---|
| 1. Is the company a shell company that has had a change in status? | ____ | ____ | ____ | ____ |

### *Disclosure Requirements*

Shell companies that complete transactions in which they cease being shell companies are required to report the material terms of the transactions under Item 5.06 within four business days. (For Form 20-F, such transactions need to be reported under Item 4.)

***References: Form 8-K, Item 5.06, Form 20-F, Instructions to Item 4A4; Division of Corporation Finance Presentation at the 2006 National Conference on Current SEC and PCAOB Developments, Slides 33–38 (not reproduced); SEC Speech, Dorsey 2006***

**Form 8-K, Item 5.06, Form 20-F, Item 4; SEC Speech, Dorsey 2006**

***Form 8-K: Current Report***

ITEM 5.06 CHANGE IN SHELL COMPANY STATUS.

If a registrant that was a shell company, other than a business combination related shell company, as those terms are defined in Rule 12b-2 under the Exchange Act, has completed a transaction that has the effect of causing it to cease being a shell company, as defined in Rule 12b-2, disclose the material terms of the transaction. Notwithstanding General Instruction B.3. to Form 8-K, if any disclosure required by this Item 5.06 is previously reported, as that term is defined in Rule 12b-2 under the Exchange Act, the registrant may identify the filing in which that disclosure is included instead of including that disclosure in this report.

***Form 20-F, Item 4***

INSTRUCTIONS TO ITEM 4A4

1. If you are providing the information called for by Item 4.A.4 in an annual report, you only have to provide the required information for the period from the beginning of your last full financial year up to the latest practicable date.
2. If you are filing a report under Rule 13a-19 or Rule 15d-19 under the Exchange Act, you must disclose the material terms of the transaction as a result of which you ceased to be a shell company and you should file as an exhibit under Item 4(a) of the Exhibits to Form 20-F any contracts relating to the transaction.



***Speech by SEC Staff***

Remarks before the 2006 AICPA National Conference on Current SEC and PCAOB Developments

By Louise M. Dorsey
Associate Chief Accountant
Office of the Chief Accountant
U.S. Securities and Exchange Commission

December 12, 2006

*As a matter of policy, the Securities and Exchange Commission disclaims responsibility for any private publication or statement of any SEC employee or Commissioner. This speech expresses the author's views and does not necessarily reflect those of the Commission, the Commissioners, or other members of the staff.*

...

Shell Company Reporting

Next, I would like to discuss reporting issues in the year of consummation of a shell company reverse merger. The shell company 8-K rules that came out in 2005 require a domestic shell company to file an 8-K within four business days of a reverse merger with an OpCo, and include all the content required by a Form 10. Foreign registrants need to file a Form 20-F for a shell reverse merger that includes all the content required by a Form 20-F, since they do not file 8-Ks. A shell company reverse merger is considered to be like an initial registration under the 1934 Act for the OpCo accounting acquirer. As such, the financial statements of the OpCo are viewed as issuer financial statements and should be audited for all periods following PCAOB standards, not US GAAS standards. However, note that the audit firm is not required to be PCAOB registered until they issue an audit report that is dated after the consummation of the reverse merger.

This differs from a reverse merger between two operating companies where the legal acquiree is a private company. For those mergers, the legal acquiree/accounting acquirer financial statements may be audited following US GAAS because the financial statements are Regulation S-X 3-05 financial statements, not those of an issuer or a predecessor to an issuer. Of course, financial statements in 10-Ks or 10-Qs filed after the merger took place would need to be audited or reviewed following PCAOB standards for all periods, as the financial statements now are those of an issuer.

When the 8-K is filed shortly after year end or quarter end, the most recent year end or quarter end is generally not included in the financial statements. Exchange Act Rules 13a-1 and 13a-13 are designed to prevent a gap in reporting after a conventional IPO by requiring the filing of an annual or quarterly report that includes the most recent year or quarter end. Keep in mind that the basic requirement for the 8-K or 20-F is to provide all the content required by a Form 10/10-SB or 20-F registration statement. [*Editor's note*: Effective February 4, 2008, the SEC has eliminated Regulation S-B. Qualifying smaller reporting companies must follow Article 8 of Regulation S-X.] Similarly, an OpCo should not have a gap in reporting after a merger with a shell company.

For illustrative purposes, assume that the OpCo qualifies as a non-accelerated filer, which normally is the case. For a domestic shell company where the

http://www.pbookshop.com

*Balance Sheet"); SEC Speech Carr December 8, 2008 (see Chapter 1, Question 8, under "Financial Reporting Presentation—Balance Sheet"); ASC 820-10-35-51A through 51H (not reproduced); ASC 820-10-55-59A through 55-59I (not reproduced)*

---

[*Editor's note*: The following items of excerpted text have not been updated to reflect the ASC.]

**SEC Speech, Hunsaker 2007; Sample Letters Dated March 2008 and September 2008 Sent to Public Companies Regarding the Application of Statement 157**

***Speech by SEC Staff***

Remarks before the 2007 AICPA National Conference on Current SEC and PCAOB Developments

By Stephanie L. Hunsaker
Associate Chief Accountant
Division of Corporation Finance
U.S. Securities and Exchange Commission
Washington, D.C.

December 11, 2007

*As a matter of policy, the Securities and Exchange Commission disclaims responsibility for any private publication or statement by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or of the author's colleagues upon the Staff of the Commission.*

. . .

Before I wrap up, just a few other points I want to mention: The first relates to those registrants that may have early adopted SFAS 157, and as a result of the current credit environment, may have decided that certain assets or liabilities were no longer classified as Level 2 instruments, but instead as Level 3 instruments. To the extent there are material reclassifications between the different levels, the staff thinks registrants should consider providing disclosure not only about the types of instruments that were reclassified, but also the nature of the inputs that the registrant felt were no longer observable. For example, instead of simply stating that XX amount of U.S. sub-prime residential mortgage related assets and asset-backed security collateralized debt obligation positions (ABS CDO) were transferred to Level 3 assets due to decrease in observability of market pricing for those instruments, consider outlining which specific market inputs were no longer observable. Additionally, it may be necessary to also discuss how you determined the fair value of the instruments in light of reduced availability of market inputs, including discussing the key assumptions used.

. . .

***Sample Letter Sent to Public Companies on MD&A Disclosure Regarding the Application of SFAS 157 (Fair Value Measurements)***

In March 2008, the Division of Corporation Finance sent the following illustrative letter to certain public companies identifying a number of disclosure issues they

http://www.pbookshop.com



may wish to consider in preparing Management's Discussion and Analysis for their upcoming quarterly reports on Form 10-Q.

March 2008

Name
Chief Financial Officer
XYZ Corporation
Address

Dear Chief Financial Officer:

Item 303 of Regulation S-K requires you to discuss, in your Management's Discussion and Analysis, any known trends or any known demands, commitments, events or uncertainties you reasonably expect to have a material favorable or unfavorable impact on your results of operations, liquidity, and capital resources. We note that you reported a significant amount of asset-backed securities, loans carried at fair value or the lower of cost or market, and derivative assets and liabilities in your financial statements in your recent Form 10-K. Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* defines fair value, provides a framework for you to measure the fair value of your assets and liabilities, and requires you to provide certain disclosures about those measurements.

Fair value assumes the exchange of assets or liabilities in orderly transactions. Under SFAS 157, it is appropriate for you to consider actual market prices, or observable inputs, even when the market is less liquid than historical market volumes, unless those prices are the result of a forced liquidation or distress sale. Only when actual market prices, or relevant observable inputs, are not available is it appropriate for you to use unobservable inputs which reflect your assumptions of what market participants would use in pricing the asset or liability. Current market conditions may require you to use valuation models that require significant unobservable inputs for some of your assets and liabilities. As a consequence, as of January 1, 2008, you will classify these assets and liabilities as Level 3 measurements under SFAS 157.

In this letter, we highlight some disclosure matters relating to SFAS 157 that you may wish to consider as you prepare your Form 10-Q. Given the judgment you must apply in using unobservable inputs to determine the fair value of your assets and liabilities, your use of them can have a material effect on your results of operations, liquidity, and capital resources, where for example, the fair value you determined falls within a broad range.

If you conclude that your use of unobservable inputs is material, please disclose in your MD&A, in a manner most useful to your particular facts and circumstances, how you determined them and how the resulting fair value of your assets and liabilities and possible changes to those values, impacted or could impact your results of operations, liquidity, and capital resources. Depending on your circumstances, the following disclosure and discussion points may be relevant as you prepare your MD&A:

- The amount of assets and liabilities you measured using significant unobservable inputs (Level 3 assets and liabilities) as a percentage of the total assets and liabilities you measured at fair value.
- The amount and reason for any material increase or decrease in Level 3 assets and liabilities resulting from your transfer of assets and liabilities from, or into, Level 1 or Level 2.

***Speech by SEC Staff***

Remarks before the 2006 AICPA National Conference on Current SEC and PCAOB Developments

By Sondra Stokes
Associate Chief Accountant
Office of the Chief Accountant
U.S. Securities and Exchange Commission

December 13, 2006

*As a matter of policy, the Securities and Exchange Commission disclaims responsibility for any private publication or statement of any SEC employee or Commissioner. This speech expresses the author's views and does not necessarily reflect those of the Commission, the Commissioners, or other members of the SEC staff.*

. . .

Critical Accounting Estimates

MD&A is also a good place to disclose information about the areas that are the most sensitive to material change from external factors. Disclosure of critical accounting estimates may be appropriate where the impact of the estimates and assumptions on financial condition or operating performance is material. Disclosure becomes particularly important when the nature of the estimates or assumptions is potentially volatile, either due to the level of judgment necessary to account for highly uncertain estimates and assumptions, or when the estimates and assumptions are readily susceptible to change.

I believe that the disclosure surrounding critical accounting estimates has the potential to be some of the most relevant and important disclosure found in the document. After all, the average lay person often doesn't understand, or at least appreciate the extent to which the use of estimates and assumptions is inherent in the preparation of financial statements. Once you move outside of this conference, there is a risk that users of financial statements may assume when they see audited financial statements that the numbers are the numbers—it is black and white, and there is little, if any, gray. As you well know, that simply isn't true, particularly as accounting moves towards the use of fair value. So it becomes increasingly important to make sure that the use of estimates and assumptions in the preparation of financial statements is adequately communicated to the users of the financial statements.

Unfortunately, all too often I see a discussion of critical accounting estimates that merely repeats the accounting policy disclosure found in the footnotes to the financial statements. Let's be clear here; an accounting policy footnote is not a synonym for a critical accounting estimate disclosure—the objectives are not the same. Ideally, the critical accounting estimates discussion would provide insights into the quality and variability of information regarding financial condition and operating performance. Rather than describing the method used to apply an accounting principle, the discussion of critical accounting estimates presents an analysis of the uncertainties involved in applying a principle at a given time or the variability that is reasonably likely to result from its application over time. This is a perfect example of avoiding duplicative information in MD&A. You've already got the accounting policy disclosure in the financial statements—MD&A can be the avenue to explain what the application of those policies means.



The first step is to make sure it is clear why the accounting estimates or assumptions bear a risk of change. In order to communicate this point, you may wish to consider a discussion of items such as:

- How the estimate was arrived at; how accurate the estimates or assumptions have been in the past; how much the estimate or assumption has changed in the past; and what are some of the drivers in past and expected variability; and
- Whether the estimate or assumption is reasonably likely to change in the future.

Because critical accounting estimates and assumptions are based on matters that are highly judgmental, you should consider discussing the sensitivity of such estimates or assumptions to change, providing a quantified sensitivity analysis when possible. As a general rule, we see far too little quantification, and you should be aware that the staff does issue comments where we believe quantification would provide meaningful information to an investor.

That being said, too much of anything, even a good thing, can still be, well, too much. Limit your discussion of critical accounting estimates to only the most critical so as not to obscure the truly critical ones. These might include the valuation of long-lived assets (including the calculation of impairment charges), goodwill and other intangibles, pensions and other post employment benefits, liabilities and reserves, derivatives and financial instruments, revenue recognition, income taxes, and environmental conservation costs. But please don't use that as a comprehensive list or an all-inclusive one, or think just because I mentioned it that every registrant should be talking about it. The discussion of critical accounting estimates is specific to each company.

***Speech by SEC Staff***

Remarks before the 2007 AICPA National Conference on Current SEC and PCAOB Developments

By Stephanie L. Hunsaker
Associate Chief Accountant
Division of Corporate Finance
U.S. Securities and Exchange Commission
Washington, D.C.

December 11, 2007

*As a matter of policy, the Securities and Exchange Commission disclaims responsibility for any private publication or statement by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or of the author's colleagues upon the Staff of the Commission.*

Good Morning, it is an honor and a privilege to again speak at this conference. Today it is my desire to discuss three topics that have been the subject of staff comment this past year: (1) Requirement to name and obtain consents from experts, (2) Presentation of a change in accounting from the consolidation

http://www.pbookshop.com