

These slides were presented at the Forums on Auditing in the Small Business Environment hosted by the PCAOB during 2010. Participants were auditors from smaller registered public accounting firms. The slides are intended to provide a sampling of issues that the Staff of the Division of Corporation Finance ("CF" or the "Division") frequently encounters when reviewing filings for smaller public companies as well as an overview of developments within the Division. Comments issued by the CF Staff may be different or additional to those included here based upon individual facts and circumstances. The slides are accompanied by detailed notes that provide additional context.

Disclaimer

The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. Therefore, the views expressed today are those of the speaker, and do not necessarily reflect the views of the Commission or the other members of the Staff of the Commission.

Agenda

- Overview of the Division of Corporation Finance
- Recent Developments
- The Comment Letter Process
- Financial Reporting Issues Frequently Raised in Comment Letters
- Resources



Overview of the Division of Corporation Finance Mission – "To see that investors are provided with

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

- Selectively review the disclosure documents filed by public companies (including initial registrations)
- Provide interpretive assistance to companies on SEC rules and forms
- Propose new and revised rules to the Commission
 Organization
- 11 industry groups
- Legal and Regulatory Policy Offices

The Division assists the Securities and Exchange Commission (the "Commission") in executing its responsibility to oversee corporate disclosure of important information to the investing public. Corporations are required to comply with regulations pertaining to disclosure that must be made when stock is initially sold and then on a continuing and periodic basis. The Division Staff routinely reviews the disclosure documents filed by companies. The Staff also provides companies with assistance interpreting the Commission's rules and recommends to the Commission new or revised rules for adoption.

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

The Division provides administrative interpretations of the Securities Act of 1933, the Securities Exchange Act of 1934, and the Trust Indenture Act of 1939, and recommends regulations to implement these statutes. The CF Staff provides guidance to registrants, prospective registrants, and the public to help them comply with the law and related regulations. For example, a company might ask whether the offering of a particular security requires registration with the SEC. The Division may share its interpretation of the relevant securities regulations with the company and give its informal advice orally on compliance with the appropriate disclosure requirement. The Division uses no-action letters and interpretive letters to provide guidance on the regulations in a more formal manner.



Key SEC Developments **Commission Actions** Dodd-Frank Act Rulemaking and Studies SEC seeking comment on regulatory initiatives required by Dodd-Frank Act Section 404(b) for Non-Accelerated Filers Facilitating Shareholder Director Nominations Proxy Disclosure Enhancements Includes changes to presentation and measurement of executive compensation for equity awards Commission Statement in Support of Convergence and **Global Accounting Standards** Two Notices of public comment on consideration of incorporating IFRS Into the financial reporting system for U.S. issuers OCA issued a Progress Report on October 29, 2010 Short-Term Borrowings Proposed Rule and Interpretive Release

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

Additional information about final rules such as Facilitating Shareholder Director Nominations and Proxy Disclosure Enhancements can be found at http://www.sec.gov/rules/final.shtml.

Additional information about the Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers and related Commission actions can be found at http://www.sec.gov/spotlight/globalaccountingstandards.shtml. This includes the progress report issued by the SEC Staff in OCA on October 29, 2010 at http://www.sec.gov/spotlight/globalaccountingstandards/workplanprogress102910.pdf

Additional information about the Commission's proposed rule on short-term borrowings disclosures and related interpretive release can be found at http://www.sec.gov/rules/proposed/2010/33-9143.pdf and http://www.sec.gov/rules/proposed/2010/33-9143.pdf and http://www.sec.gov/rules/proposed/2010/33-9143.pdf and http://www.sec.gov/rules/interp/2010/33-9143.pdf and http://www.sec.gov/rules/interp/2010/33-9144.pdf, respectively.

Key SEC Developments

Staff Initiatives

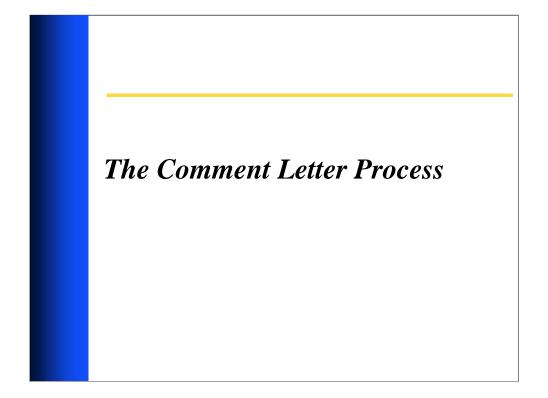
- Division of Corporation Finance Financial Reporting Manual Updates
- Corporation Finance Compliance and Disclosure Interpretations on Non-GAAP Financial Measures
 - http://www.sec.gov/divisions/corpfin/guidance/nongaapinterp. htm
- Sample letter Sent to Public Companies Asking for Information Related to Repurchase Agreements, Securities Lending Transactions, or Other Transactions Involving the Transfer of Financial Assets
- Sample Letter Sent to Public Companies on Accounting and Disclosure Issues Related to Potential Risks and Costs Associated with Mortgage and Foreclosure-Related Activities or Exposures

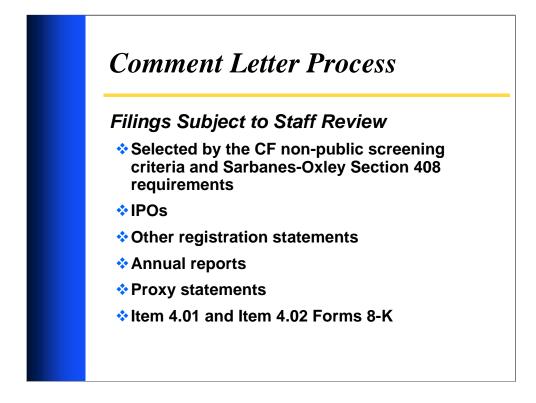
In December 2008, the CF Staff published the Division's Financial Reporting Manual (the "Manual"). The Manual addresses various financial reporting issues, but does not address issues related to GAAP. It is designed as an internal reference document for the CF Staff; however, it has been published on the website in the interest of transparency. Due to its informal nature, it does not necessarily contain a discussion of all material considerations necessary to reach a conclusion. However, the Manual can be a helpful resource for registrants to consider in their financial reporting. The CF Staff have been updating the Manual on a quarterly basis.

The CF Staff also publishes Compliance and Disclosure Interpretations ("CDIs") on the Division of Corporation Finance page of the SEC website. These interpretations replaced the previously published Telephone Interpretations Manual. They are categorized by rule, regulation or form and are updated on a regular basis. Recently, the CF Staff posted a series of CDIs relating to the use of non-GAAP financial measures that revised the CF Staff's previously issued Frequently Asked Questions ("FAQ") document on the same topic. The objectives of the revisions to the previously issued guidance are to: 1) allow preparers to include non-GAAP financial measures in their filings with the Commission that they deem useful for investors, provided they comply with Item 10(e) of Regulation S-K, 2) address diversity in practice as it relates to the use of non-GAAP financial measures and 3) consolidate staff positions that have been documented in various places since the publication of the FAQ document.

The CF staff sent a letter to certain large financial institutions at the end of March 2010 requesting information about repurchase agreements, securities lending transactions and other transactions involving the transfer of financial assets with an obligation to repurchase the transferred assets. The letter is publicly available on our website.

Additionally, in October 2010, the CF Staff sent letters to certain public companies as a reminder of their disclosure obligations to consider in light of continued concerns about potential risks and costs associated with mortgage and foreclosure-related activities or exposures.





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

In addition, the CF Staff generally reviews each Form 8-K filed on Items 4.01 and 4.02 for compliance with the disclosure requirements and issues comment letters as necessary.

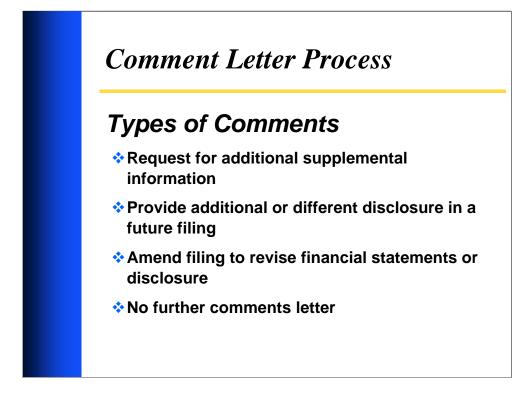
Levels of Review

If the Division selects a filing for review, the level of review may be:

•a full cover-to-cover review in which the CF Staff will examine the entire filing for compliance with the applicable requirements of the federal securities laws and regulations;

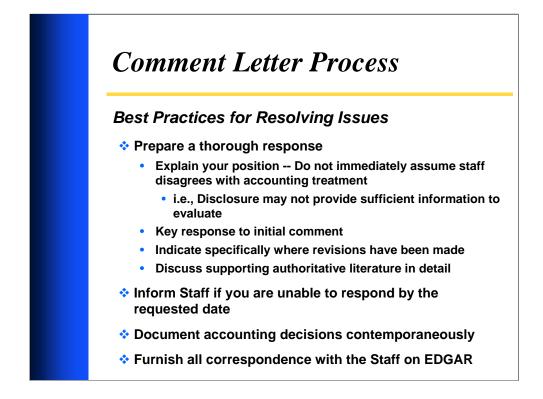
•a financial statement review in which the CF Staff will examine the financial statements and related disclosure for compliance with the applicable accounting standards and the disclosure requirements of the federal securities laws and regulations; or

•a targeted issue review in which the CF Staff will examine the filing for one or more specific items of disclosure for compliance with the applicable accounting standards and/or the disclosure requirements of the federal securities laws and regulations.



The Division's comments are in response to a company's disclosure and other public information and are based on the CF Staff's understanding of that company's facts and circumstances. In issuing comments to a company, the CF Staff may request that a company provide additional supplemental information so we can better understand the company's disclosure, revise disclosure in a document on file with the Commission, provide additional disclosure in a document on file with the Commission, or provide additional or different disclosure in a future filing with the Commission.

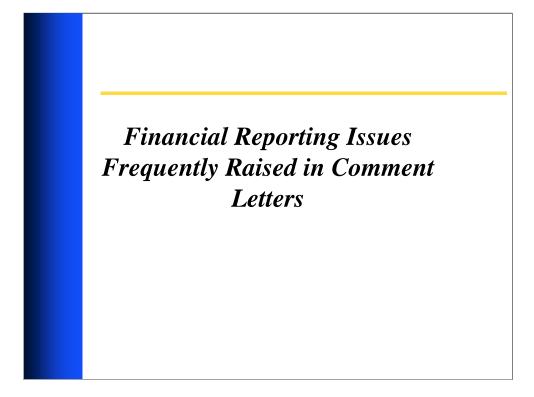
A company generally responds to each comment in a letter to the CF Staff. A company's explanation or analysis of an issue will often satisfactorily resolve a comment. Depending on the nature of the issue, the CF Staff's concern, and the company's response, the CF Staff may issue additional comments following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



It is helpful when registrants take the time to prepare a thorough response. A good response focuses on the specific questions asked by the CF Staff, yet is sufficiently robust to allow the CF Staff to fully understand the accounting and/or disclosure at question. If the registrant has revised its filing or plans on revising its filing in response to the CF Staff's comments, it is also very helpful to provide proposed disclosure or marked pages. If the CF Staff has asked a question on the registrant to refer to any specific literature in GAAP that it relied upon to reach its conclusions. Providing a detailed and complete explanation to the CF Staff in response to the initial comment letter may lessen the likelihood of future comments or at least narrow the scope of the issue. This can minimize the rounds of comment letters issued.

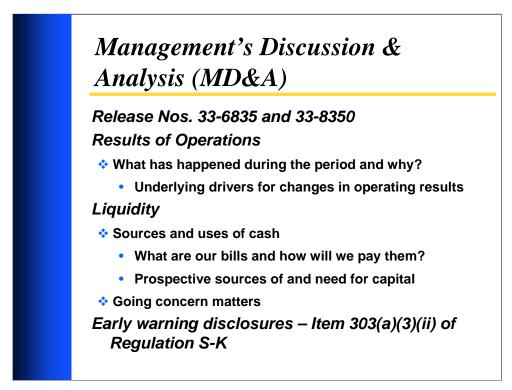
If you are unable to respond by the date requested in the letter, you can contact the CF Staff and discuss the date on which you expect to respond. The CF Staff will often request that registrants file letters requesting an extension on EDGAR with the date at which they intend to respond.

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



Financial Reporting Issues Frequently Raised in Comment Letters

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



MD&A has three general objectives: to provide a narrative explanation of a company's financial statements through the eyes of management; to enhance the overall financial disclosure and provide the context within which financial information should be analyzed; and to provide information about the quality of, and potential variability of, a company's earnings and cash flow, so that investors can ascertain the likelihood that past performance is indicative of the future. In accomplishing these objectives, CF Staff generally recommends that companies provide an overview highlighting BOTH financial and non-financial key performance indicators as background to understanding the company's overall performance for the periods. The CF Staff often finds that registrants do not adequately discuss the factors contributing to fluctuations in operating results from period to period beyond what is readily apparent from the face of the financial statements. The discussion of fluctuations should help readers understand the operational factors that contributed to changes in underlying line items and the magnitude of their impact.

The liquidity discussion of a registrant's sources and uses of cash may be an area where disclosure is rapidly evolving for a smaller growing company. In providing a discussion of liquidity, the registrant should discuss how it funds its operations by considering what its significant bills are and how it pays those bills. In addition, to the extent the registrant will need additional capital in the future – for example, in order to grow through acquisition or fund operations – the registrant should consider providing a clear discussion of the source of that capital and the consequences if it is unable to obtain capital including a discussion of any going concern considerations.

MD&A requires registrants to disclose known uncertainties that the registrant reasonably expects will have a material impact on income from continuing operations. Using goodwill as an illustration, registrants may want to consider, for example, providing appropriate disclosures when they have triggered an impairment test and come close to failing Step 1. Similarly, in cases where they have actually failed Step 1, but concluded that an impairment charge is not necessary under Step 2, disclosure could also be useful to put investors "on notice." Finally, registrants may want to consider warning investors in situations where they have not yet triggered an interim impairment test, but events that are reasonably likely to occur may require it in the near future. The CF Staff may issue comments to companies in situations where the events that trigger an impairment or other charge appear to have been predictable in an earlier period but the circumstances were not previously addressed in disclosure.

Reverse Mergers & "Back Door" Registrations

What is a "back door" registration? Frequent Areas of Comment:

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

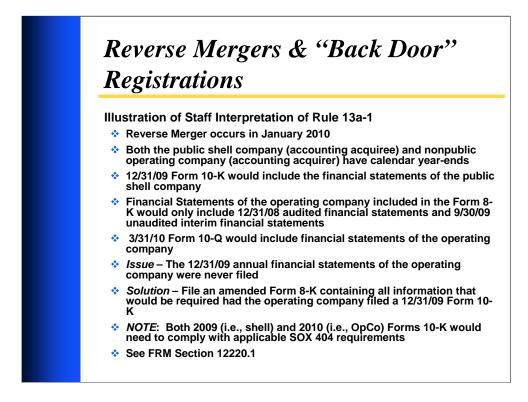
"Back door" registration refers to a private operating company merging with a public shell, thereby gaining the ability to issue public stock. This method of registration is reported on a Form 8-K rather than a 1933 Act registration statement. There are several accounting and reporting complexities with these transactions. They can be problematic in the review process because they have already been reported and consummated, therefore amendments or changes can be more complicated and burdensome compared to resolving comments on the review of a pre-effective registration statement.

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

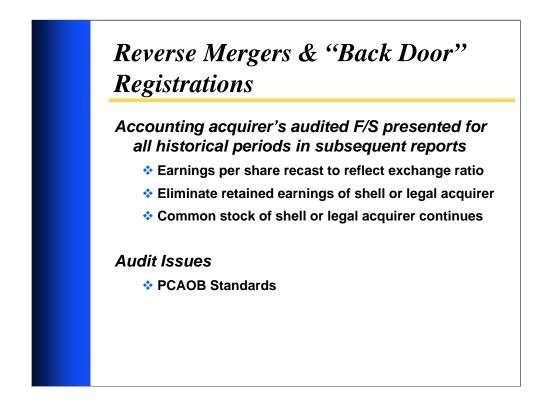
Item 9.01(c) of Form 8-K indicates that financial statements for reverse mergers with public shells must be filed within four business days. The 71-day extension under Item 9.01 for Rule 3-05 financial statements does not apply. If these are not filed within the four day deadline, the registrant may not be considered current or timely for the purposes of using certain forms. Additionally, that Form 8-K is required to include all the disclosures that the operating company or accounting acquirer would be required to present in a registration statement on Form 10.

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 initial registration by requiring the filing of an annual or quarterly report that includes the most recent year or quarter end. Similarly, an accounting acquirer should not have a gap in reporting after a merger with a shell company. Keep in mind that the basic requirement for the 8-K is to provide all the content required by a Form 10 registration statement. Therefore, CF Staff has advised registrants to file an amended 8-K to provide updated financial statements within the same timing as the periodic report would be due.

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

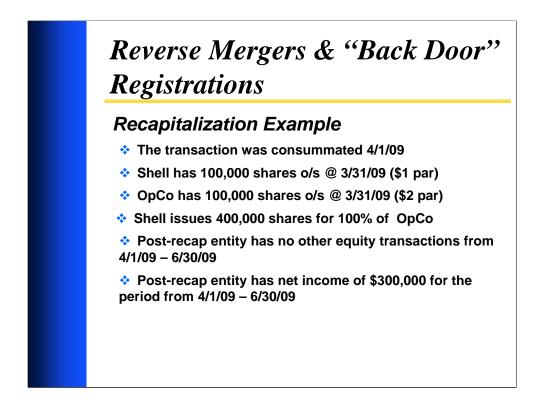


This slide provide an example of the reporting under the CF Staff Interpretation of Rule 13a-1 discussed on the prior slide.



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

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



Slides 19 through 21 provide a summarized example of reporting for a "back door" registration statement accounted for as a recapitalization. You can refer to slides 45 through 54 for additional details.

Reverse Mergers & "Back Door" Registrations

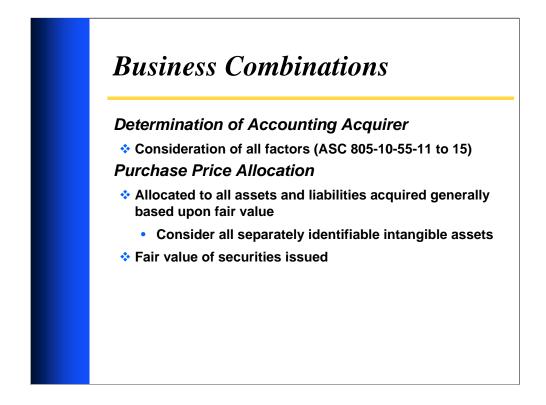
_

OpCo SSE 1/1/0)8 -				
3/31/09				Retained	
	Number	Shares		Earnings	
	of Shares	at Par (\$2)	APIC	(Deficit)	Total
1/1/08	60,000	120,000	600,000	300,000	1,020,000
Shares issued for services 7/1/08	20,000	40,000	110,000		150,000
Net Income				250,000	250,000
12/31/08	80,000	160,000	710,000	550,000	1,420,000
Shares issued for cash 2/1/09 Net Income	20,000	40,000	190,000	200,000	230,000 200,000
3/31/09	100,000	200,000	900,000	750,000	1,850,000

Reverse Mergers & "Back Door" Registrations

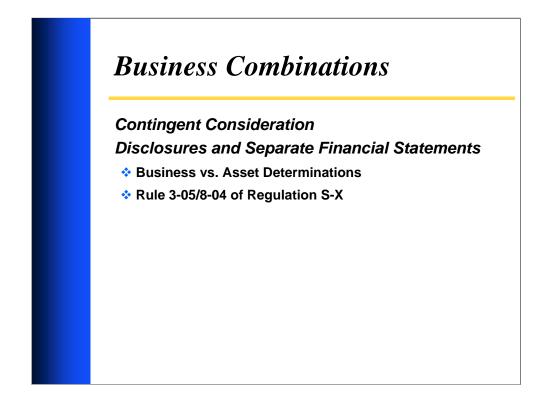
Post-Recapitalization Continuing Entity SSE 1/1/08 - 6/30/09

1/1/08 - 6/30	/09			Retained	
	Number	Shares		Earnings	
	of Shares	at Par (\$1)	APIC	(Deficit)	Total
1/1/08	240,000	240,000	480,000	300,000	1,020,000
Shares issued for services 7/1/08	80,000	80,000	70,000		150,000
Net Income				250,000	250,000
12/31/08	320,000	320,000	550,000	550,000	1,420,000
Shares issued for cash 2/1/09	80.000	80.000	150,000		230,000
Net Income	80,000		150,000	200,000	200,000
3/31/09	400,000	400,000	700,000	750,000	1,850,000
Recapitalization 4/1/09	100,000	100,000	25,000		125,000
Net Income				300,000	300,000
6/30/09	500,000	500,000	725,000	1,050,000	2,275,000



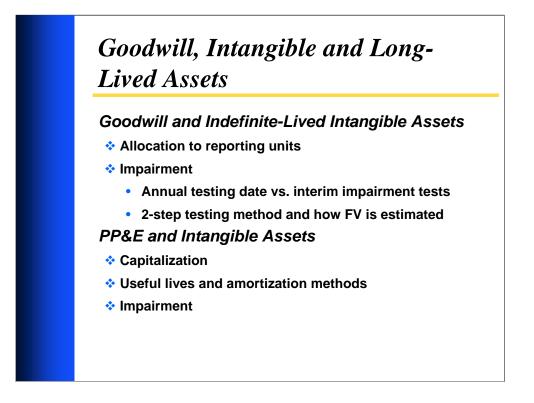
The determination of the accounting acquirer may not always be clear from the terms of the transaction. In determining the accounting acquirer, the company should consider all the indicators in FASB ASC 805-10-55-11 through 15. As the governance provisions for each company may differ, the analysis will be unique to each company based upon its individual facts and circumstances. Voting interests (including the impact of in-the-money options) are not determinative. We expect management to fully evaluate the indicators considering the disparity between the two companies in each of the factors, the rights of management as compared to stockholders as compared to the boards of directors, as appropriate, as well as how the individual factors interact with each other.

The CF Staff may comment on the purchase price allocation, whether it is related to a probable acquisition and included in the notes to pro forma financial information or a consummated acquisition and included in the notes to the financial statements. In general, the CF Staff may request more information in situations where a disproportionate amount of the purchase price is allocated to goodwill. This request is even more likely if descriptions of the transaction indicate that other intangible assets may have been acquired, but no fair value is assigned.



Smaller registrants may enter into business combinations with family-owned enterprises that are significant to the registrant. If such transactions include additional consideration to be paid to any of the family members based upon future performance of the acquired business, the registrant should evaluate FASB ASC paragraph 805-10-55-25 in situations in which any family members continue to be employed by the registrant. Any arrangements that are linked to continued employment subsequent to the transaction are deemed to be compensation rather than additional purchase price, which can significantly impact the financial statements for periods subsequent to the transaction.

Because of the difficulty in obtaining pre-acquisition financial statements of an acquired business months after the transaction is closed, it is important to fully evaluate the Commission's requirements for separate financial statements and pro forma financial information prior to the transaction being consummated. Rule 11-01(d) of Regulation S-X defines a business for determining when separate financial statements are required to be filed with the Commission. The principle in the rule is whether there is sufficient continuity in the revenue generating activity so that preacquisition financial statements would be meaningful to investors. It is important to note that this may yield different results than the evaluation performed for the purposes of FASB ASC Topic 805. The application of Rule 3-05 compared to Rule 8-04 depends on whether the *registrant* is a smaller reporting company, not on whether the target would qualify as a smaller reporting company. Under Rule 8-04 there is no requirement to provide more than two years audited financial statements for the acquired business. Under Rule 3-05, a third year is required if the transaction was greater than 50% significant and the target had revenues of at least \$50 million in its most recent year.



- The staff continues to issue comments related to operating segments. In addition to ensuring that companies comply with the segment disclosures required by FASB ASC Topic 280, the staff may use these comments to better understand the identification of reporting units for goodwill impairment purposes and how goodwill is allocated among those reporting units.
- GAAP requires that companies consider whether an event has occurred that "would more likely than not reduce the fair value of a reporting unit below its carrying value." In reviewing disclosures, CF Staff may consider certain publicly available information in and out of the company's filings in assessing whether it seems likely that such an event has occurred. It may be helpful for companies to consider the following events or indicators in considering whether an interim impairment test is appropriate: (1) other impairment charges; (2) cash or operating losses at reporting unit level; (3) industry factors; (4) revisions to forecasts; and (5) restructuring plans.
- Generally, the assumptions used to value goodwill should be consistent with assumptions used in valuing other assets allocated to the reporting unit such as long-lived assets, intangible assets, and deferred tax assets. For example, if the reporting unit for a retail chain is a particular store or geographic area, we would expect the estimated future cash flows and discount rates related to acquired franchise rights, customer relationships, and in some cases, PP&E to be impacted in a similar fashion as goodwill by current events.
- Capitalization policies selected by companies are subject to significant judgment. There is specific guidance related to certain industries or types of costs, but not as much general guidance. In cases where the registrant's cost capitalization policies may materially impact its financial statements, and where the CF staff believes there to be diversity in practice, we may request robust disclosures about the registrant's policies and the quantified impact of those policies.
- The CF Staff may raise questions if companies conclude that acquired intangible assets have indefinite lives when some of the factors in FASB ASC paragraph 350-30-35-3 may be present. The CF Staff may also comment in situations in which a registrant appears to be defaulting to the straight-line method of amortization when there appears to be clear evidence of another pattern in which the economic benefits of the asset are consumed.

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

The assessment of whether predecessor financial statements are required is separate from the identification of the accounting acquirer. In certain cases, a newly formed entity may have a predecessor, or an entity with nominal operations that purchases a business for cash also may have a predecessor. When a registrant succeeds to substantially all of the operations of another entity, that entity is the registrant's predecessor. In these situations, audited financial statements of the predecessor and successor are expected to be presented for periods required by Regulation S-X with no lapse in audited periods. In addition, Regulation S-K requires Management's Discussion and Analysis covering the financial statements of the predecessor and successor. *In addition to discussing the historical periods, the staff accepts the use of pro forma information (not combined financial statements) in addition to this historical information to facilitate the discussion.*

The CF Staff will request that registrants include the predecessor's financial statements not only in a registration statement at the time the transaction is consummated, but also in any subsequent periodic reports until the predecessor periods are no longer covered by the periodic report. Those financial statements should be audited up to the acquisition date with no gap in periods. Additionally, the company should consider the need to continue including the pre-transaction financial statements of the registrant unless there is only nominal income statement activity (including financing income and costs and merger costs).

Predecessor Financial Statements

Example

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

Predecessor Financial Statements

Example (Cont.)

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

Equity Transactions

Fair Value Determination

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

Disclosure

- All major assumptions used to value stock options, warrants and other equity instruments
 - Footnotes
 - MD&A (critical accounting estimates)
 - o Sensitivity analysis

When smaller companies incorrectly determine fair value for equity issued to consummate certain transactions, such as compensation arrangements and business combinations, it can often lead to material misstatements. CF Staff will frequently comment if a registrant has used a value different from quoted market price to value its equity if it is determined that the stock trades in an active market. GAAP does not permit blockage discounts if using quoted market price. Discounts for trading restrictions may be appropriate in certain circumstances provided they are characteristics of the security and can be supported with objective evidence. If the stock does not trade in an active market, the CF Staff may look to cash transactions with third parties for the same security in close proximity to support fair value or otherwise may consider the fair value of the services and/or goods received if that measure is more reliable. While quoted market price may not be the appropriate measure of fair value in inactive markets, that price should not be ignored when determining fair value. Absent market prices in an active market or other objective measures of fair value, management should use its judgment considering the fair value hierarchy in determining a fair value that is supportable.

Because of the significant impact that fair value determinations can have on the financial statements, it is helpful for registrants to provide disclosure surrounding how the fair value was determined and the impact that reasonable changes in assumptions could have on the measure and on the financial statements directly.

<section-header> Babbadded Conversion Options and pressuading Warrants Scope * Applies to all contracts that are indexed to, and potentially settled in a company's own stock (e.g., warrants, many conversion options) * See FASB ASC 815-40-15 Common Pitfalls * Cash settlement provisions * Insufficient authorized shares * No limit on # of shares to be delivered * Incorrect conclusion on whether instrument is indexed to a company's own stock * Tractchet Provisions" -- paragraphs 33 and 34 of FASB ASC 815-40-55 (Example 8 of ETF 07-5)

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

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

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

You can find additional information on slides 55 and 56 later in the presentation.

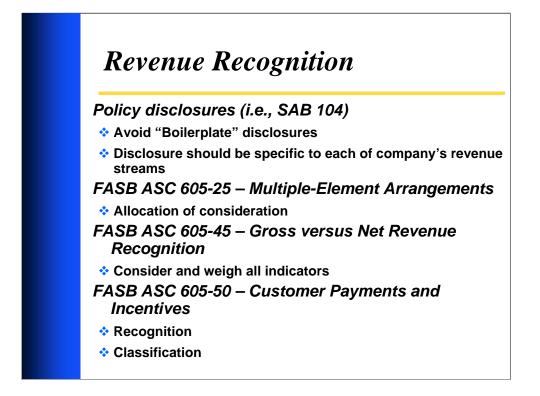
Embedded Conversion Options and Freestanding Warrants (cont'd)

Valuation Issues

- Inappropriate model being used to value certain derivatives
 - Black-Scholes may not be appropriate in many situations given complex features and terms of conversion option (e.g., combined embedded derivatives)
- Evaluate the provisions of your agreements (Debenture, warrant, reg. rights, anti-dilution provisions, etc.) carefully

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

The staff frequently finds that errors in this area are the result of companies not carefully considering and evaluating the accounting implications of provisions of their agreement at the time they are negotiating them or when the transaction is completed.

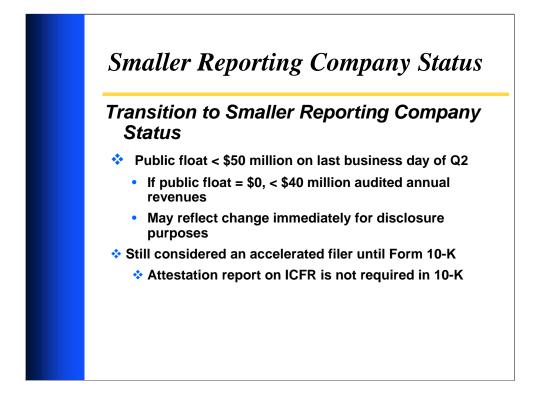


CF Staff frequently requests clarification of how companies recognize revenue, including how their revenue recognition is consistent with Staff Accounting Bulletin No. 104, which provides guidance on how to apply generally accepted accounting principles to revenue recognition issues. We also ask companies to expand their revenue recognition accounting policy disclosures. In many cases, these comments are raised because of overly vague or "boilerplate" disclosures. Registrants should take care to fully disclose the timing and method for recognizing revenue for each of their material revenue streams.

As it relates to revenue recognition under ASC Subtopic 605-25, the CF Staff frequently comments in situations where it is not clear whether the deliverables qualify as separate units of accounting. In such situations, the CF Staff may ask the registrant how it evaluated each of the criteria to conclude that the delivered item could be considered a separate unit of accounting. With the issuance of ASU 2009-13, we expect multiple deliverables to more frequently qualify as separate units; however, we may be more likely to have comments on the identification of all deliverables and the allocation of revenue to the deliverables because of the significant amount of judgment involved.

The CF Staff may comment when companies recognize revenue on a gross basis and the disclosures raise questions as to whether registrant is really acting as an agent and should be reporting revenue on a net basis. The opposite may occur where revenue is presented on a net basis, but the registrant's business appears to be more in line with that of a principal. If there is not transparent disclosure in MD&A or elsewhere as to how the registrant reached its conclusions, the Staff may comment and ask how the registrant has evaluated each of the indicators in ASC Subtopic 605-45, and which specific indicators carry the most weight in their fact pattern.

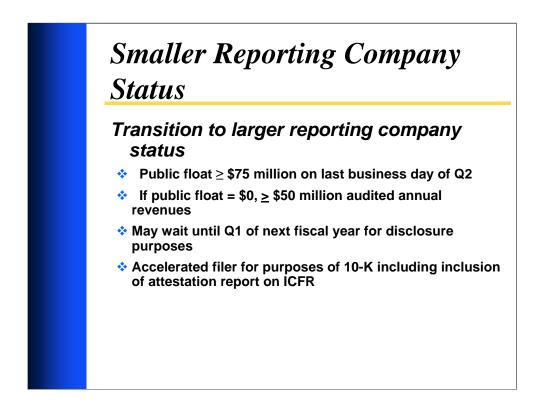
Similar to multiple-element arrangements discussed above, the CF Staff may comment on transactions in which there are payments or other incentives provided by a vendor to customer. The CF Staff will consider whether the accounting aligns with the economic substance of the transactions. For example, there is a presumption that payments made from a vendor to a customer are reduction of revenues unless the vendor is obtaining some identifiable benefit.



The SEC adopted a new system of disclosure rules for smaller companies filing periodic reports and registration statements that was effective in 2008. They are scaled to reflect the characteristics and needs of smaller companies and their investors. They replace the disclosure requirements formerly in the SEC's Regulation S-B, which applied to "small business issuers."

Unlike Regulation S-B, companies that have a public float need only consider that float in their test. The revenue test only applies to companies with no public float.

While the thresholds may align with the thresholds for filer status (i.e., nonaccelerated or accelerated), the test is for different purposes and there may be circumstances where a smaller reporting company is an accelerated filer or where a larger reporting company is a nonaccelerated filer. If a company newly qualifies as a smaller reporting company based upon its second quarter public float, it may elect to provide the scaled disclosure in its next quarterly report on Form 10-Q. While the company can provide the scaled disclosure immediately, it is still considered an accelerated filer. If a company is required to exit smaller reporting company status, it may continue to report as a smaller reporting company through the filing of the annual report on Form 10-K for that year. However, while a company in this fact pattern may still provide scaled disclosure in the Form 10-K, it must report as an accelerated filer for purposes of the Form 10-K deadline and the inclusion of the attestation report on internal control over financial reporting required by Section 404(b) of the Sarbanes-Oxley Act.



See prior slide for related speaker notes.

Disclosure Controls & Procedures

Conclusions

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

Incomplete definition of DC&P

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

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

Internal Control over Financial Reporting (ICFR)

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

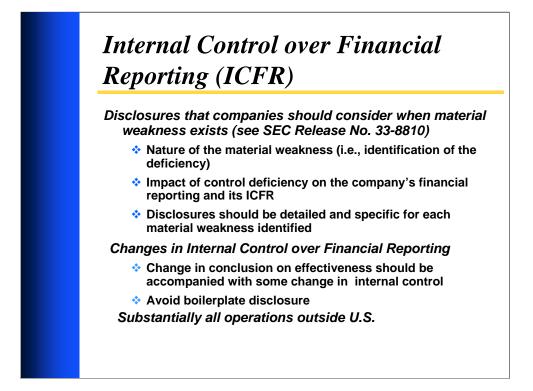
- Separate evaluation and assessment from evaluation of disclosure controls and procedures
- All four elements in Item 308(a) must be addressed in disclosure
- ICFR cannot be "effective" if material weakness exists
- Clear conclusion (either "effective" or "ineffective")

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

Include all paragraphs (including paragraph 4(b))

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

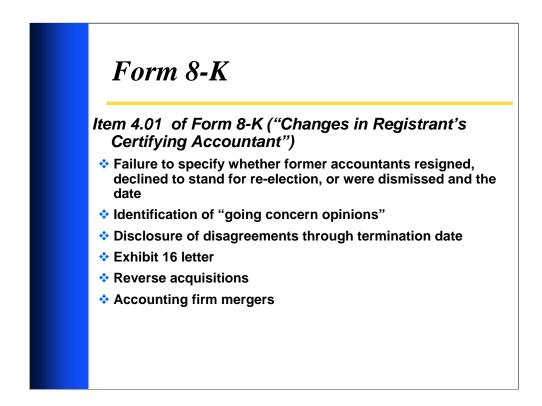
From a compliance perspective, companies subject to the auditor attestation requirement must disclose all four elements required by Item 308(a) of Regulation S-K (non-accelerated filers must only disclose the elements relevant for their purposes). As it relates to the framework, the Commission specified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



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

The disclosures required by Item 308(c) of Regulation S-K pertaining to Changes in Internal Control over Financial Reporting are intended to alert investors to circumstances that may create risk through their effect on registrants' internal control. Since these disclosures are required on a quarterly basis, they are helpful in providing timely information that may speak to the quality of a company's financial reporting in any given period and provide an update from the company's most recent annual evaluation of internal control over financial reporting. The CF Staff may issue comments when there is "boilerplate" disclosure that there have been no material changes in the period in situations when conclusions have changed from one year to the next or other identifiable events exist such as layoffs, change in an outsourcing arrangement, or changes in accounting policy. If a company's conclusion on effectiveness changes from ineffective to effective without ever disclosing changes, the staff may comment not only on the lack of disclosures in the interim reports, but also on the conclusion.

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



As they relate to Item 4.01 Form 8-Ks, the CF Staff's comments are generally focused on compliance with the item requirements.

The CF Staff may ask for more information and disclosure about the facts and circumstances surrounding the change in accountants. For example, in situations in which the company has dismissed its independent accountant because it has been involuntarily deregistered by the PCAOB, we believe companies should disclose that fact.

Two other areas in which the CF Staff frequently comments are:

•The CF Staff considers an explanatory paragraph in the audit report describing uncertainty about the company's ability to continue as a going concern to be a report modification as to uncertainty as discussed in Item 304 of Regulation S-K that should be disclosed in the Form 8-K.

•The CF Staff also views the "subsequent interim period" since the most recent year-end for the purposes of disclosing disagreements to include the period through the termination date. As a result, the CF Staff has requested that companies revise their disclosure if the entire period is not covered already by the disclosure.

The CF Staff may also comment if the Exhibit 16 letter signed by the former accountants has not been filed in a timely manner.

Finally, such Form 8-Ks will usually need to be filed upon the consummation of a reverse merger or upon merger of the registrant's accountants with another firm.

Form 8-K

Most Item 4.02 ("Non-Reliance on Previously Issued Financial Statements") comments relate to Item 4.02(a) –

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

As they relate to Item 4.02 Form 8-Ks, again comments will generally be focused on compliance with the item requirements. Companies should provide a description of the facts and circumstances leading to the conclusion of nonreliance, including the triggering event that led to the conclusion. The triggering event should be the conclusion that previously issued financial statements can no longer be relied upon rather than the restatement of those financial statements. Finally, companies should clearly state the periods for which the financial statements can no longer be relied upon and quantify the impact of that determination to the extent known.

Form 8-K generally allows registrants to disclose reportable items in periodic reports coming due if the event occurs within the four business days before the due date of the periodic report. Notwithstanding, the CF Staff expects registrants to always report the need to restate financial statements under Item 4.02 on Form 8-K rather than in another periodic report as discussed in Form 8-K CDI 215.01.





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

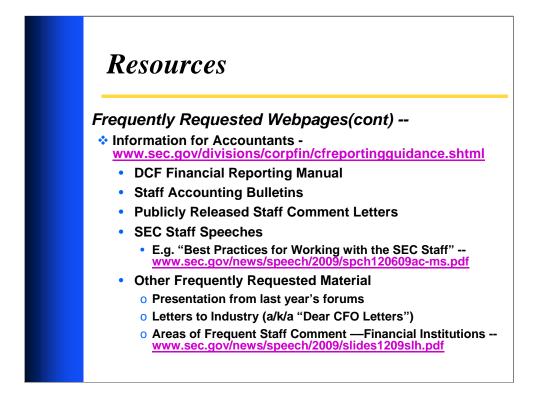
> •*Filing Review Process* --- This document provides a detailed explanation of the CF Staff's review process including some of the information covered earlier in this presentation, in addition to listing important contacts throughout the Division.

•*Statutes, Rules, and Forms* – This link can be used to research certain statutes impacting the Commission, various Commission rules and regulations, and item requirements for various SEC forms.

•*Compliance & Disclosure Interpretations* -- This page includes legal interpretative positions taken by the CF Staff on various rules, regulations, and forms categorized by topic.

•*What's New?* – This link is helpful to stay current to changes and new items being added to the Division webpage on a weekly basis.

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



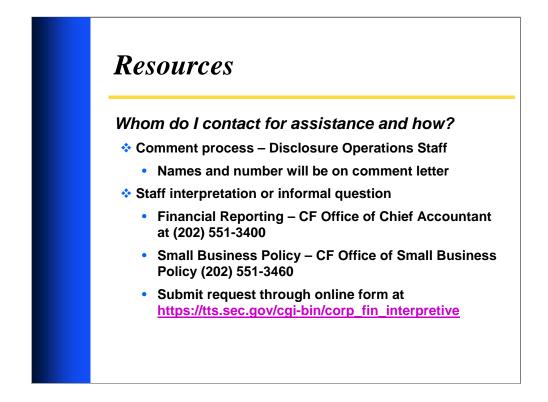
In addition to the information presented on the previous slide, preparers and their auditors can also access additional information via a link on both the Commission's and Division's respective homepages that have various resources relating to accounting and financial reporting.

Specifically, preparers and auditors can access the Division of Corporation Finance Financial Reporting Manual. In addition, this section includes Staff Accounting Bulletins which reflect the Commission staff's views regarding accounting-related disclosure practices. They represent interpretations and policies followed by the Division and the Office of the Chief Accountant ("OCA") in administering the disclosure requirements of the federal securities laws.

Comment letters issued by the CF Staff to specific registrants and their corresponding responses can be accessed at <u>http://www.sec.gov/answers/edgarletters.htm</u>. These letters are generally uploaded to the public website 45 days after the review process has concluded.

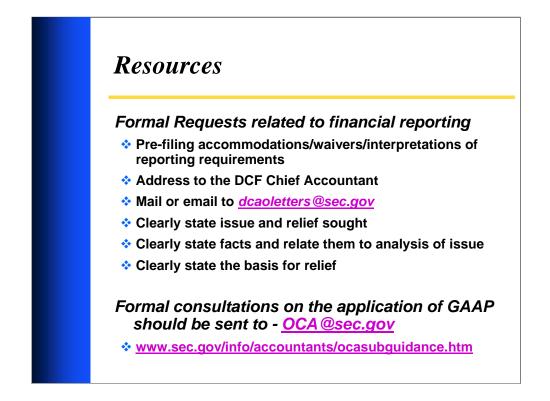
Selected staff speeches, which is non-authoritative guidance given by staff in the Division and the Office of the Chief Accountant, can also be found on this webpage. In addition these speeches, smaller issuers and their auditors may find the presentation on "Best Practices for Working with the SEC Staff" and the "Areas of Frequent Staff Comment —Financial Institutions" helpful.

Finally, the "Dear CFO Letters" are sample letters sent to certain companies to address emerging disclosure issues for consideration in advance of preparing disclosures. However, they are posted to the website with the intent of being useful to a broader population of registrants.



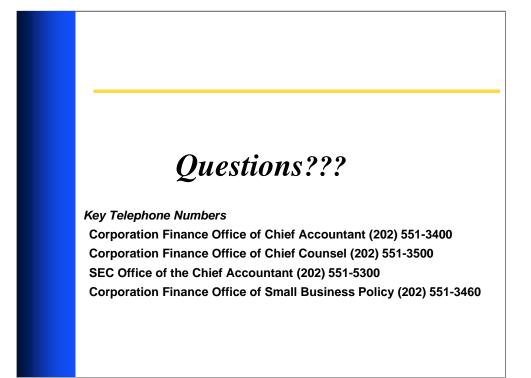
It may be helpful to contact the CF Staff if you do not fully understand comments included in any comment letter to ensure you respond to the CF Staff in a complete manner. Additionally, it may be helpful to contact the CF Staff as it relates to timing or other questions about the comment process. In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

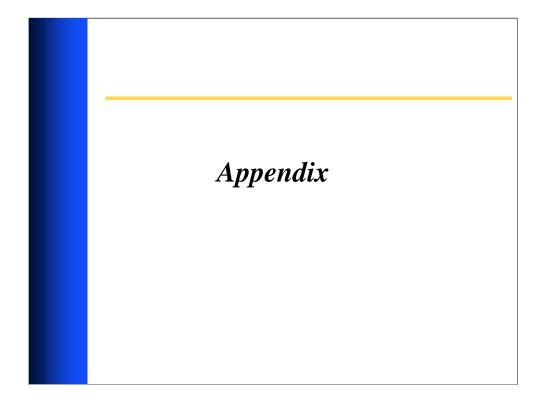
Additionally, The CF Staff is available to assist with general interpretive and other questions regarding the federal securities laws and reporting equirements it helps the Commission to administer. Each Legal and Regulatory Policy Office, including the Corporation Finance Office of Chief Accountant and the Corporation Finance Office of Small Business Policy have staff members available to answer such questions on a daily basis. In addition to calling the office directly at the phone numbers listed above, registrants, their advisors and auditors can expedite a response by using the Division's online form at https://tts.sec.gov/cgi-bin/corp_fin_interpretive. In this case, the registrant or its advisors or auditors can provide detailed information regarding the specific question that will be sent directly to a staff member who can consider the facts and respond to the question directly in a more timely manner.



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

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





Recapitalization Example

- The transaction was consummated 4/1/09
 - Shell has 100,000 shares o/s @ 3/31/09
 - OpCo has 100,000 shares o/s @ 3/31/09
 - Shell issues 400,000 shares for 100% of OpCo
- Other Information
 - Post-recap entity has no other equity transactions from 4/1/09 – 6/30/09
 - Post-recap entity has net income of \$300,000 for the period from 4/1/09 6/30/09

Recapitalization Example

Balance Sheets @ 3/31/09	Shell	ОрСо
Cash	\$ 200,000	\$ 50,000
Assets Other than Cash		2,000,000
Total Assets	\$ 200,000	\$ 2,050,000
Liabilities	\$ 75,000	\$ 200,000
Shell Common Stock (\$1 par) 100,000 shares o/s	100,000	
OpCo Common Stock (\$2 par) 100,000 shares o/s		200,000
APIC	125,000	900,000
Retained Earnings (Deficit)	(100,000)	750,000
Total Equity	125,000	1,850,000
Total Liabilities & Equity	\$ 200,000	\$ 2,050,000

Shell SSE 1/1/08 - 3/31/09

Shell SSE 1/1/08 - 3/31/09	Number of Shares	Shares at Par (\$1)	APIC	Retained Earnings (Deficit)	Total
1/1/08 Shares issued for	40,000	40,000		(60,000)	(20,000)
services 2/1/08	30,000	30,000	60,000		90,000
Net Loss				(10,000)	(10,000
12/31/08 Shares issued for cash	70,000	70,000	60,000	(70,000)	60,000
3/1/09	30,000	30,000	65,000		95,000
Net Loss				(30,000)	(30,000
	100,000	100,000	125,000	(100.000)	125,000

OpCo SSE 1/1/08 - 3/31/09

OpCo SSE				Retained	
1/1/08 - 3/31/09	Number	Shares		Earnings	
	of Shares	at Par (\$2)	APIC	(Deficit)	Total
1/1/08	60,000	120,000	600,000	300,000	1,020,00
Shares issued for services 7/1/08	20,000	40,000	110,000		150,00
Net Income				250,000	250,00
12/31/08	80,000	160,000	710,000	550,000	1,420,00
Shares issued for cash 2/1/09	20,000	40,000	190,000		230,00
Net Income				200,000	200,00
3/31/09	100,000	200,000	900,000	750,000	1,850,00

Post-Recapitalization Continuing Entity SSE 1/1/08 - 6/30/09

	Number	Shares		Retained Earnings	
	of Shares	at Par (\$1)	APIC	(Deficit)	Total
1/1/08	240,000	240,000	480,000	300,000	1,020,000
Shares issued for services 7/1/08 Net Income	80,000	80,000	70,000	250,000	150,000 250,000
12/31/08	320,000	320,000	550,000	550,000	1,420,000
Shares issued for cash 2/1/09 Net Income	80,000	80,000	150,000	200,000	230,000 200,000
3/31/09	400,000	400,000	700,000	750,000	1,850,000
Recapitalization 4/1/09 Net Income	100,000	100,000	25,000	300,000	125,000 300,000
6/30/09	500,000	500,000	725,000	1,050,000	2,275,000

Post-Recapitalization Continuing Entity SSE 1/1/08 - 6/30/09 (cont'd)

	OpCo reco	eived 4 shares for each o/s share: Exchange Ratio of 4:1
Α	\$1	Equals par value of Shell
в	80,000	Use 4 for 1 Exchange Ratio. 20,000 shares x 4 = 80,000
С	\$80,000	80,000 shares x \$1 par value = \$80,000
D	\$70,000	\$150,000 from (E) below - \$80,000 from (C) above
Е	\$150,000	No change from OpCo pre-recap SSE
F	\$200,000	No change from OpCo pre-recap SSE
G	\$200,000	No change from OpCo pre-recap SSE
н	400,000	Should agree to number of shares issued to OpCo by Shell
I.	\$400,000	400,000 shares x \$1 par value = \$400,000
		\$1,850,000 from (L) below - \$750,000 from (K) below - 400,000
J	\$700,000	from (I) above
Κ	\$750,000	No change from OpCo pre-recap SSE
L	\$1,850,000	No change from OpCo pre-recap SSE
Μ	100,000	Number of o/s shares at Shell pre-recap
Ν	\$100,000	100,000 shares x \$1 par value = \$100,000
0	\$25,000	\$125,000 from (P) below - \$100,000 from (N) above
Ρ	\$125,000	Net assets of shell pre-recap
	BCDEFGHI JKLMNO	A \$1 B 80,000 C \$80,000 D \$70,000 E \$150,000 F \$200,000 G \$200,000 H 400,000 I \$400,000 J \$770,000 K \$750,000 L \$1,850,000 M 100,000 N \$100,000 O \$25,000

Shell & OpCo Historical EPS

<u> </u>	Recap Histor		
	12/31/0	08 03/	31/0
Net Loss	\$ (10,000	0) \$ (30	,000
EPS	\$ (0.1	5) \$ (0.38
Weighted Average Number of Shares	C7 E0	o or	
Number of Shares	67,50	0 00),000
OpCo Pre-	Recap Histor	ical EPS	
	12/31/0	08 03/	31/0
Net Income	\$ 250,00	0 \$ 200	,000
EPS	\$ 3.5	57 \$	2.14
Weighted Average			
Number of Shares	70,00	0 93	3,333

Continuing Entity EPS

	12/31/08	03/31/09	06/30/09
Net Income	\$ 250,000	\$ 200,000	\$ 500,000
EPS Weighted Average Number of Shares	\$ 0.89 280,000	\$ 0.54 373,332	\$ 1.15 436,667

Continuing Entity EPS (cont'd)

OpCo received 4 shares for each o/s share: Exchange Ratio of 4:1 \$250,000 No change from OpCo pre-recap Net Income А \$250,000 / 280,000 weighted avg. shares = \$0.89 В \$0.89 Use 4 for 1 Exchange Ratio. 70,000 OpCo pre-recap weighted 280,000 avg. shares x 4 = 280,000 weighted avg. shares С \$200,000 No change from OpCo pre-recap Net Income D \$0.54 \$200,000 / 373,332 weighted avg. shares = \$0.54 Е Use 4 for 1 Exchange Ratio. 93,333 OpCo pre-recap weighted avg. shares x 4 = 373,332 weighted avg. shares F 373,332 G \$1.15 \$500,000 / 436,667 = \$1.15 (320,000 shares x 6/6 = 320,000) + (80,000 shares x 5/6 = 66,667) + (100,000 shares x 3/6 = 50,000) = 436,667 weighted avg. 436,667 shares н

Embedded Conversion Options and Freestanding Warrants Analysis Is the instrument within scope of ASC 480-10-15 (SFAS 150)? Analyze under ASC 815 (SFAS 133) – two routes Freestanding Analyze whether a derivative under SFAS 133 Perform ASC 815-40 (EITF 00-19) and ASC 815-40-15 (EITF 07-5) analysis to see if scope exception in ASC 815 is available If scope exception met, account for as equity If no scope exception met, and the option meets the definition of a derivative, account for as a derivative liability (ASC 815/SFAS 133)

This is necessarily an abbreviated outline of a common process for evaluating warrants and conversion options that does not necessarily consider every step that may be required in all facts and circumstances.

Generally, the first step is to determine whether the instrument is within the scope of FASB ASC Topic 480. If the instrument is within the scope of that literature, the instrument should be classified and measured using the guidance in that literature.

If the financial instrument is a freestanding warrant and is not within the scope of FASB ASC Topic 480, it may be within the scope of FASB ASC Topic 815. If the warrant is indexed to a company's own stock under FASB ASC Subtopic 815-40, companies should evaluate that Subtopic to determine whether the instrument should be classified within equity with no adjustments for changes in fair value or classified as a liability at fair value with adjustments each period.

Embedded Conversion Options and Freestanding Warrants (cont.)

2. Embedded

- Perform ASC 815-40 (EITF 00-19) and ASC 815-40-15 (EITF 07-5) analysis to see if scope exception in ASC 815 is met for conversion option
- If scope exception is met, no bifurcation required, but consider beneficial conversion feature under ASC 470-20 (EITF 98-5 and 00-27)
- If no scope exception is met, and the definition of a derivative is met, account for as a derivative liability (all embedded derivatives should be combined and accounted for as a single compound embedded derivative)

As it relates to hybrid financial instruments, such as convertible debentures, embedded features must be analyzed under FASB ASC 815-15-25-1 to determine whether they should be bifurcated and accounted for separately under FASB ASC Topic 815 as an embedded derivative. A key component in that analysis is determining whether the embedded feature is clearly and closely related to the host contract. Clearly and closely related, additional analysis is required to determine whether the feature should be bifurcated. Companies should consider the staff's views in EITF Topic D-109 on determining the nature of the host contract when the hybrid financial instrument is in the form of a share. Understanding the nature of the host contract often is a key component in determining whether an embedded feature is clearly and closely related to its host (for instance, a conversion option into equity shares would often be C&CR to an equity host contract but not C&CR to a debt host contract).

If the embedded feature is not clearly and closely to the host instrument (FASB ASC 815-15-25-1a) and the entire hybrid instrument is not accounted for at fair value through earnings (FASB ASC 815-15-25-1b), companies should analyze whether the embedded feature would be considered a derivative if it were a freestanding instrument (FASB ASC 815-15-25-1c). That analysis requires an evaluation of whether the feature has the characteristics of a derivative (FASB ASC 815-10-15-83) and whether any scope exception to derivative accounting would be met (FASB ASC 815-10-15).

If an embedded conversion feature is not bifurcated under FASB ASC Topic 815, companies should consider whether there is a beneficial conversion feature to be accounted for under FASB ASC Subtopic 470-20. Whether a feature is bifurcated or not, the company should consider EITF Topic D-98 and ASR 268 if the instrument is redeemable in determining the classification and measurement of the host contract.