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SEC Regulations Committee and SEC Staff Hold First Meeting of 2007

SEC Staff Provides Views on Interpretation 48 Issues That Affect Interim Reports

By Deloitte & Touche LLP's Accounting Standards and Communications and SEC Services Groups

On April 17, 2007, the SEC Regulations Committee ("Regulations Committee") held its first meeting of the year with the SEC staff. The Regulations Committee is composed of representatives from various public accounting firms, industry, and academia, and meets periodically with the SEC staff to discuss emerging technical accounting and reporting issues related to SEC rules and regulations.

SEC Staff Discussions Regarding Ongoing Projects, Final Rule Releases, and Other Matters

In addition to discussing the agenda items relating to technical accounting and reporting issues, the SEC staff discussed ongoing projects, final rule releases, and other matters.

Update of Ongoing Projects in the Office of the Chief Accountant

Conrad Hewitt, chief accountant in the SEC's Office of the Chief Accountant (OCA), provided status updates on various projects in the OCA, including the following:

- Internal Control Guidance for Management — The OCA staff is working toward finalizing its guidance, with a final rule release expected in May 2007. The PCAOB staff is working to release Auditing Standard 5 at the same time. (See Deloitte & Touche's January 8, 2007, and April 10, 2007, issues of *Heads Up* for further discussion.)
- International Financial Reporting Standards (IFRS) and International Convergence — The OCA staff is continuing to work toward implementing the steps in the IFRS Roadmap. After the Regulations Committee meeting, the SEC issued a press release announcing a series of next steps, including the future release of two documents. The first document will be a proposing release that will request comment on an approach allowing the use of IFRS in financial reports filed by foreign private issuers without reconciliation to U.S. GAAP. The second document will be a concept release that will request comment on whether U.S. issuers should be permitted to use IFRS in preparing their financial reports.

- Materiality — Staff members in the OCA are working with their counterparts in the Division of Corporation Finance ("Corporation Finance") on this project. Being reviewed is SAB 99[1] and its treatment of items that are qualitatively material and quantitatively immaterial, or qualitatively immaterial and quantitatively material. Issues related to interim materiality are also being considered.
- Statement 159[2] — The OCA staff is monitoring implementation issues relating to Statement 159. (For more information related to Statement 159, see Deloitte & Touche's February 22, 2007, *Heads Up* and Accounting Alerts 07-5 and 07-6.)

Update of Ongoing Projects in the Division of Enforcement

Susan Markel, chief accountant in the SEC's Division of Enforcement, provided status updates on various projects in the Division of Enforcement, including the following:

- Stock Option Backdating Investigations — The Division of Enforcement currently has over 100 active investigations related to stock option backdating. Staff members in the Division of Enforcement are working closely with their counterparts in the OCA.
- In addition to investigating stock option backdating, the Division of Enforcement is examining other matters such as revenue recognition and earnings management.

Update of Ongoing Projects in the Division of Corporation Finance

Preliminary Review of Registrant Filings

- The Corporation Finance staff noted that it has not seen any new trends during its current review of domestic registrant filings. The SEC staff is finishing its reviews of Form 20-F for last year and has continued to note lack of proper disclosures related to IFRS, revenue recognition, and consolidations. They have also noted issues related to income statement presentation.

Alerts to Be Issued by Corporation Finance or the OCA

- Corporation Finance and the OCA have indicated in the past that they will, from time to time, issue alerts or letters containing guidance and factors for registrants to consider in evaluating filings. Both staffs stated that there are no alerts forthcoming in the near future.

Current Accounting and Disclosure Issues

- In November 2006, Corporation Finance published an updated version of its Current Accounting and Disclosures Issues and plans to issue another updated version in May 2007. The SEC staff noted that the November 2006 edition contained an error related to the proper aggregation treatment of a segment that is not considered a reportable segment. The SEC staff noted that this error will be corrected in the May 2007 update.

Comments Received on Executive Compensation Interim Final Rule

- The SEC staff is currently considering comment letters received on the SEC's Interim Final Rule on Executive Compensation Disclosures. The SEC staff hopes to issue a final rule in May 2007, but in the interim, registrants should follow the existing guidance. See Deloitte & Touche's January 8, 2007, *Heads Up* for further discussion.

Regulation S-X Rules 3-10 and 3-16 Matters

Between its regularly scheduled meetings with the SEC staff, the Regulations Committee may also address emerging issues with the SEC staff as warranted. The Regulations Committee recently discussed with the SEC staff

[1] SEC Staff Accounting Bulletin No. 99, *Materiality*.
[2] FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*.

the application of Rule 3-10[3] and Rule 3-16,[4] which provide guidance to registrants on financial statement and disclosure requirements when their registered securities are guaranteed or collateralized.

Because of the limited amount of published interpretive guidance on these subjects, the Regulations Committee stated that additional guidance would help ensure that investors are receiving the necessary information and that registrants understand the reporting requirements for guarantees and collateral arrangements.

As a result of the discussions, two final discussion documents that contain the SEC staff's view on certain issues related to the application of Rule 3-10 and Rule 3-16 were recently posted to the CAQ's page on the AICPA's Web site. Topics addressed include the following:

- Application of Rule 3-16 issues, including:
  - o Updating requirements for Rule 3-16 financial statements.
  - o Applicability of other Regulation S-X rules to Rule 3-16 financial statements.
  - o Performing the substantial collateral test under Rule 3-16.
  - o Applicability of Rule 3-16 after the deregistration of the underlying collateralized securities or the termination of the associated collateral arrangement.
  - o Interpreting the term "Class of Securities" when applying Rule 3-16.
- Application of Rule 3-10 when a registrant acquires an entity that has outstanding registered debt.

Summary of SEC Staff Views on Issues Discussed With Regulations Committee

The following is a brief description of each issue that was part of the agenda discussed at the April 17, 2007, meeting. The attached Appendix contains more background information and details of the views expressed. (Readers may click any description or title to be taken to a detailed description in the Appendix).

Issue Description	Discussion Document Title
Whether registrants are required to include tax liabilities recorded in accordance with Interpretation 48 in the tabular disclosure of contractual obligations in management's discussion and analysis (MD&A) for interim and annual periods.	Disclosure of FIN 48 Liabilities in the Contractual Obligations Table
How a registrant should consider interest related to uncertain tax positions when calculating the ratio of earnings to fixed charges.	Determining the Amount of Interest on FIN 48 Liabilities to Be Included in Fixed Charges for Purposes of Calculating the Ratio of Earnings to Fixed Charges
How a private company with a postretirement employee benefit plan(s) that files an initial public equity offering during 2007 should consider the transition provisions of Statement 158.	Application of FAS 158 in Connection With an Initial Public Equity Offering
How an entity that undertakes a public equity offering and pays a dividend to its owners or promoters should calculate pro forma earnings per share when the amount of the dividend to be paid at or prior to the closing exceeds both the last 12 months earnings plus the proceeds received from the equity offering.	Applying SAB Topic 1.B.3. When the Dividend to Be Paid Exceeds Both the Last Twelve Months Earnings and the Proceeds From the Equity Offering

3 SEC Regulation S-X, Rule 3-10, "Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered."

4 SEC Regulation S-X, Rule 3-16, "Financial Statements of Affiliates Whose Securities Collateralize an Issue Registered or Being Registered."

Issue Description	Discussion Document Title
Requirements for a public limited partnership to provide a more recent balance sheet for a nonpublic general partner when the public limited partnership makes a transactional filing.	Balance Sheet Updating Requirements Relating to the Non-Public General Partner of a Public Limited Partnership
Periods for which a well-known seasoned issuer (WKSI) must provide executive compensation disclosures when the WKSI files a Form S-4 before its definitive proxy statement that includes the required executive compensation disclosures for the most recent fiscal year.	Timeliness of Executive Compensation Disclosures in the Form S-4 Registration Statement of a Well-Known Seasoned Issuer
How a registrant should calculate and present the fair value of share-based payment awards granted during a fiscal year with performance conditions in the Grant of Plan-Based Awards Table required by the executive compensation disclosures.	Grant Date Fair Value of Equity Award With Performance Conditions in Grants of Plan-Based Awards Table (Item 402(d)(2)(viii) of Regulation S-K)
Whether a non-accelerated filer that voluntarily furnishes a management report on internal control over financial reporting (ICFR) before December 15, 2007, may omit an attestation report on ICFR from its independent registered public accounting firm for that period.	Application of Item 308T of Regulations S-K and S-B to a Non-Accelerated Filer That Early Adopts Internal Control Reporting by Management
How a subsidiary that was recently spun-off from its parent determines its accelerated filer status.	Determining Accelerated Filer Status for a Company That Was Recently Spun-Off From an SEC Registrant-Parent (Update to Discussion Document C from the June 2004 Meeting)
Whether it is acceptable to provide combined financial statements of entities under common control that complete a merger that will occur at the time of effectiveness of the initial public offering (IPO) or after the IPO becomes effective, but no later than the closing of the IPO.	Financial Statement Requirements in an IPO When a Merger of Entities Under Common Control Occurs at the Closing Date
How a registrant should determine whether separate financial information or summarized financial information is required when an investment is accounted for using the fair value option under Statement 159 rather than under the equity method.	Application of Rules 3-09 and 4-08(g) of Regulation S-X to Investments Accounted for Using the Fair Value Option Under Statement of Financial Accounting Standards No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" That Otherwise Would Be Accounted for Under the Equity Method Under APB 18, "The Equity Method of Accounting for Investments in Common Stock"

Appendix: Background Information and Details on Views Expressed

Disclosure of FIN 48 Liabilities in the Contractual Obligations Table

Registrants are required by Regulation S-K, Item 303(a)(5)[5] to include in the MD&A section a tabular disclosure of all known contractual obligations, such as long-term debt, capital and operating lease obligations, purchase obligations, and other long-term liabilities recorded in accordance with GAAP. Item 303(b) of Regulation S-K does not require the contractual obligations table to be included in interim filings, but rather, the registrant should disclose material changes in its contractual obligations outside the ordinary course of the registrant's business that occur during the interim periods.

Interpretation 48[6] requires entities to record liabilities associated with unrecognized tax benefits ("Interpretation 48 liabilities") because they represent potential future obligations to a taxing authority. In her remarks at the 2006 AICPA National Conference on Current SEC and PCAOB Developments, Jenifer Minke-Girard, senior associate chief accountant in the SEC's Office of the Chief Accountant, stated that Interpretation 48 liabilities should be disclosed in the contractual obligations table, along with disclosure in the footnotes to the table on the assumptions used to estimate when the liabilities will actually be cash settled. (See Deloitte & Touche's December 21, 2006, *Heads Up* for further discussion.)

Question 1: The Regulations Committee asked the SEC staff to confirm that the contractual obligations table should include Interpretation 48 liabilities for unrecognized tax benefits recorded in accordance with Interpretation 48.

SEC Staff View 1: The SEC staff stated that a registrant should include Interpretation 48 liabilities in the contractual obligations table in MD&A if it can make reasonably reliable estimates about the period of cash settlement of the liabilities. For example, if any Interpretation 48 liabilities are classified as a current liability in the registrant's balance sheet, a registrant should include that amount in the "Less than 1 year" column of its contractual obligations table. Similarly, the contractual obligations table should include any noncurrent Interpretation 48 liabilities for which the registrant can make a reasonably reliable estimate of the amount and period of related future payments (e.g., uncertain tax positions subject to an ongoing examination by the respective taxing authority for which settlement is expected to occur beyond the next operating cycle). However, there is often a high degree of uncertainty regarding the timing of future cash outflows associated with some Interpretation 48 liabilities. In those cases, a registrant might be unable to make reasonably reliable estimates of the period of cash settlement with the respective taxing authority (e.g., unrecognized tax benefits for which the statute of limitations might expire without examination by the respective taxing authority). In those circumstances, a registrant could exclude Interpretation 48 liabilities from the contractual obligations table, or disclose such amounts within an "other" column added to the table. To the extent any Interpretation 48 liabilities are excluded from the contractual obligations table or included in an "other" column, a footnote to the table should disclose the amounts excluded and the basis for such exclusion.

Question 2: The Regulations Committee also asked the SEC staff what the required disclosures would be in the interim period of adoption of Interpretation 48 related to the contractual obligations table, particularly since the amounts recorded in the interim period of adoption could represent a material change from the contractual table in the previously filed Form 10-K.

SEC Staff View 2: The SEC staff indicated that in the first Form 10-Q reflecting adoption of Interpretation 48, the registrant should provide either (1) a complete contractual obligations table, updated for any material amounts related to Interpretation 48 liabilities, or (2) narrative disclosures regarding any material effects of Interpretation 48 liabilities on the contractual obligations table, similar to that described in SEC Staff View 1 related to the inclusion of Interpretation 48 liabilities in the contractual obligations table.

5 SEC Regulation S-K, Item 303, "Management's Discussion and Analysis of Financial Condition and Results of Operations."
6 FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*.

Determining the Amount of Interest on FIN 48 Liabilities to Be Included in Fixed Charges for Purposes of Calculating the Ratio of Earnings to Fixed Charges

Regulation S-K, Item 503(d)[7] defines fixed charges as the sum of the following:

> (a) interest expensed and capitalized, (b) amortized premiums, discounts and capitalized expenses related to indebtedness, (c) an estimate of the interest within rental expense, and (d) preference security dividend requirements of consolidated subsidiaries.

Question: Because the definition of the calculation of the ratio of earnings to fixed charges does not address how a registrant should consider interest related to Interpretation 48 liabilities within the calculation, the Regulations Committee asked the SEC staff how such interest should be considered in the calculation of the ratio.

SEC Staff View: The SEC staff did not require either the inclusion or exclusion of interest on Interpretation 48 liabilities as a fixed charge. However, the SEC staff stated that a registrant's accounting policy for income statement classification of interest on Interpretation 48 liabilities should not necessarily dictate that registrant's method of computing the ratio of earnings to fixed charges. The SEC staff expects transparent disclosure discussing treatment of interest on Interpretation 48 liabilities and other types of interest on non-third-party indebtedness when calculating the ratio of earnings to fixed charges.

Application of FAS 158 in Connection With an Initial Public Equity Offering

Statement 158[8] requires entities that have publicly traded equity securities to adopt the Statement's recognition provisions beginning with fiscal years ending after December 15, 2006. All other companies must adopt the recognition provisions no later than fiscal years ending after June 15, 2007. Further, Statement 158 states that the recognition provisions should be applied at the end of the fiscal year of initial application and should not be applied retrospectively.

Question 1: The Regulations Committee asked the SEC staff whether a private entity that is preparing a Form S-1 for an IPO prior to the completion of a fiscal year ending after June 15, 2007, should apply the recognition provisions of Statement 158 in its December 31, 2006, financial statements included in the Form S-1, as if the entity were a public company.

The following example was provided to the SEC staff.

> Company X is a private company with a calendar year-end. Company X is preparing a Form S-1 in June 2007 to undertake an initial public equity offering. The Form S-1 includes audited financial statements as of December 31, 2006 and 2005, and for each of the three years in the period ended December 31, 2006, as well as unaudited financial statements as of March 31, 2007, and for the three-month periods ended March 31, 2007, and 2006. Company X had previously prepared its December 31, 2006, financial statements for its bank and shareholders using GAAP requirements for private companies, and therefore without reflecting the adoption of Statement 158.

The SEC staff has previously held the view that an entity is generally no longer eligible for non-public-company treatment alternatives contained within accounting standards when it is in the process of becoming a public entity. Such entities must comply with public company requirements in the standards as of the date that all public companies were required to adopt the standard, even if that requires a company that is in the process of filing an IPO to restate prior-period financial statements.

SEC Staff View 1: The SEC staff stated that when preparing the equity IPO Form S-1, a private company with a calendar year-end must revise its previously issued December 31, 2006, financial statements to reflect the adoption of the recognition provisions of Statement 158 as if it had publicly traded equity securities during 2006. In addition, the recognition provisions would apply in any subsequent interim period presented.

Question 2: The Regulations Committee asked the SEC staff if the response to Question 1 would be different if the entity were a debt-only issuer prior to the equity IPO and therefore had been filing Exchange Act (Securities

7 SEC Regulation S-K, Item 503, "Prospectus Summary, Risk Factors, and Ratio of Earnings to Fixed Charges."
8 FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* — an Amendment of FASB Statements No. 87, 88, 106, and 132(R).

Exchange Act of 1934) reports with the SEC. In this situation, the entity was considered a public company because of its publicly traded debt for Exchange Act filing requirements. However, it did not meet the Statement 158 definition of a public company and therefore would not have adopted the recognition provisions of Statement 158 in the December 31, 2006, financial statements included in its prior SEC filings.

SEC Staff View 2: The SEC staff indicated that if an entity with a calendar year-end was a debt-only issuer prior to commencing its equity IPO, and had been filing Exchange Act reports, and did not early adopt the recognition provisions of Statement 158 in connection with its 2006 Form 10-K, then it **would not** be required to restate those financial statements in connection with the equity IPO. Since the recognition provisions of Statement 158 can only be adopted as of a company's fiscal year-end, the entity would not be required to adopt Statement 158 until its fiscal year ended December 31, 2007. However, the SEC staff indicated that it would not object if a debt-only issuer elected to restate its financial statements for the first fiscal year ending after December 15, 2006 (and any subsequent interim period provided in the Form S-1), to reflect the adoption of Statement 158, with clear disclosure of such restatement(s).

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

In certain circumstances, a private company may undertake an equity offering and pay a dividend to its owners or promoters. Alternatively, a subsidiary of a company may undertake an equity offering and pay a dividend to its parent. In these situations, SAB Topic 1.B.3[9] requires presentation in historical financial statements of pro forma earnings per share (EPS) for the latest fiscal year and interim period when an issuer pays a dividend to its owners or promoters at or prior to the closing of an equity offering, if the dividend to be paid exceeds both the issuer's earnings for the last 12 months plus the proceeds from the equity offering. Additionally, to fund a portion of the dividend, the private company or subsidiary may need to obtain a bank loan or other debt financing and therefore incur incremental interest expense.

Question: The Regulations Committee asked the SEC staff what amount should be used in the denominator of the pro forma EPS calculation that is presented in the historical financial statements.

SEC Staff View: The SEC staff indicated that the denominator used to calculate pro forma EPS should be the sum of the currently outstanding shares and the additional shares that will be issued in connection with the equity IPO. A company should not reflect more shares than will actually be outstanding after the offering. For example, the company should not calculate the pro forma EPS by reflecting shares that would have been issued to pay the portion of the dividend in excess of the last 12 months earnings plus the IPO proceeds as this would result in more shares than will actually be outstanding after the IPO. The SEC staff also stated that the numerator of the pro forma EPS calculation should be adjusted to reflect the incremental interest expense from the bank loan or other debt financing, net of tax, relating to the portion of the dividend that exceeds both the gross proceeds from the equity offering plus the previous 12 months earnings.

Consider the following example:

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

Subsidiary A should use 900,000 shares as the denominator in the pro forma EPS calculation calculated as follows:

Pre-existing shares	100,000
IPO shares	800,000
Pro forma shares	900,000

9 SEC Staff Accounting Bulletin Topic 1.B.3, "Allocation of Expenses and Related Disclosure in Financial Statements of Subsidiaries, Divisions or Lesser Business Components of Another Entity — Other Matters."

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

Balance Sheet Updating Requirements Relating to the Non-Public General Partner of a Public Limited Partnership

The SEC's Division of Corporation Finance Accounting Disclosure Rules and Practices Training Manual (the "Manual") Topic Two IV.D.1 requires the inclusion of an audited annual balance sheet for the general partner (whether public or nonpublic) in transactional filings of a limited partnership. The Manual further indicates that the audited balance sheet should be as of the end of the most recent fiscal year. Additionally, if there has been a fundamental change in the general partner's financial condition, a more recent balance sheet reflecting the change should be provided. Regardless, the audited balance sheet of a nonpublic general partner should be no more than six months old. When a balance sheet that is more recent than the general partner's most recent fiscal year is required, it may be unaudited.

Question 1: The Regulations Committee asked the SEC staff whether, if the transactional filing is made within 90 days of the non-public general partner's year-end, the general partner is required to update its audited balance sheet for its most recently completed fiscal year. For purposes of this question, assume the general partner is a calendar-year-end company. It has an audited December 31, 2005, balance sheet. However, its December 31, 2006, balance sheet has not been audited as of the transactional filing date. Assume the transactional filing date is prior to March 31, 2007.

SEC Staff View 1: The SEC staff indicated that as long as the general partner's balance sheet is no more than six months old, the general partner is not required to provide a more recent balance sheet (audited or unaudited). Accordingly, a transactional filing made prior to March 31, 2007, could be completed using the audited balance sheet as of December 31, 2005, and the unaudited balance sheet of the general partner as of September 30, 2006; October 31, 2006; or November 30, 2006.

Question 2: The Regulations Committee asked for clarification on the application of the six-month rule. For example, if a public limited partnership makes a transactional filing on July 2, 2007, would the registrant be required to include the general partner's balance sheet for an interim period in addition to the December 31, 2006, balance sheet of the general partner?

SEC Staff View 2: The SEC staff indicated that since six months have passed as of June 30, 2007, the general partner's balance sheet must be updated on an unaudited basis to a date within six months of the transactional filing.

Question 3: The Regulations Committee asked the SEC staff whether a general partner's audited balance sheet would be required to be updated in connection with a draw-down from an existing shelf registration if a fundamental change in the general partner's financial condition has occurred.

SEC Staff View 3: The SEC staff noted that a public limited partnership should file a post-effective amendment to its shelf registration statement to update the prospectus as required by Section 10(a)(3) of the Securities Act.[10] In addition, if there has been a fundamental change in a general partner's financial condition, the limited partnership should file a post-effective amendment to the existing registration statement and include a more recent balance sheet of the general partner reflecting such fundamental change. Otherwise, the prospectus supplement is **not** required to include a balance sheet of a nonpublic general partner that is no more than six months old.

[10] Securities Act of 1933.

Timeliness of Executive Compensation Disclosures in the Form S-4 Registration Statement of a Well-Known Seasoned Issuer

In most circumstances, an SEC registration statement must include executive compensation disclosures for a registrant's most recently completed fiscal year. A Form S-1 that is filed or declared effective after a registrant's fiscal year-end generally must include the required executive compensation disclosures for that fiscal year. To illustrate, in its Q&As[11] on Regulation S-K, Item 402,[12] the SEC staff stated that a filing made by a calendar year-end company on January 2, 20x7, must include the executive compensation information for the fiscal year ended December 31, 20x6, in situations where such information cannot be incorporated by reference into the registration statement.

The SEC staff has previously expressed a view[13] on situations in which a **non-WKSI**[14] registrant files a Form S-3 subsequent to filing its Form 10-K but omits the required executive compensation disclosures because the registrant will file the disclosures in a definitive proxy statement within 120 days after its fiscal year-end. In this case, the SEC staff stated that prior to the Form S-3 becoming effective; the registrant must either 1) file its definitive proxy statement or 2) update its Form 10-K to include the required executive compensation information.

However, the SEC staff has not objected to situations in which a **WKSI** filed an **automatic** shelf registration statement on a Form S-3 that incorporated by reference the WKSI's most recently filed Form 10-K that did not contain the required executive compensation disclosures. In other words, the WKSI's Form S-3 could have become effective upon filing even if the WKSI had not yet filed its definitive proxy statement with the executive compensation disclosures that were omitted from its Form 10-K. Questions have arisen about whether the SEC staff would allow a Form S-4 to become effective upon filing in such circumstances.

Form S-4 allows incorporation by reference if the registrant is Form S-3 eligible. Item 13 of Form S-4 requires the registrant to incorporate by reference its latest Form 10-K filed with the SEC. Items 18 and 19 of Form S-4 also require the disclosures specified in Item 402 with respect to each person who will serve as a director or an executive officer of the surviving or acquiring company.

Question: The Regulations Committee asked the SEC staff to specify the period for which a registrant that qualifies as a WKSI must provide the executive compensation disclosures required by Regulation S-K, Item 402, in a Form S-4.

SEC Staff View: The SEC staff indicated that the WKSI filing a Form S-4 must provide the executive compensation disclosures for **the most recent fiscal year for which Form 10-K has been filed**. Because a WKSI is Form S-3 eligible, its Form S-4 would only be required to provide disclosures as current as those that would be required in a Form S-3. Until the WKSI files its Form 10-K for the most recently completed fiscal year, its Form S-4 could become effective without executive compensation disclosures for the most recently completed year.

If a WKSI files a Form S-4 after filing its Form 10-K for the most recently completed fiscal year, the Form S-4 must provide executive compensation disclosures **for the most recently completed fiscal year**. If the WKSI's Form 10-K omitted the executive compensation or other items required in Part III of the Form 10-K, it must either file the definitive proxy statement or update the Form 10-K to include the required information prior to the Form S-4 becoming effective. The WKSI could, however, file a **preliminary** Form S-4 before the time that the Part III information is filed, as long as the Part III information is filed before the S-4 becomes effective.

In addition, the SEC staff noted that if the Form S-4 also relates to a proxy solicitation that involves the election of directors or the approval of matters relating to executive or director compensation (Items 8 and 10 of Schedule 14A), the Form S-4 would be required to include or incorporate by reference executive compensation disclosures for the most recently completed fiscal year even if the Form 10-K for the most recently completed fiscal year has not been filed.

[11] SEC Division of Corporation Finance's Compliance and Disclosure Interpretations — Item 402 of Regulation S-K — Executive Compensation.
[12] SEC Regulation S-K, Item 402, "Executive Compensation."
[13] SEC Division of Corporation Finance's Manual of Publicly Available Telephone Interpretations Section H.6.
[14] A WKSI is a well-known seasoned issuer, as defined by SEC Regulation C, Rule 405.

Example 1

Registrant A has a December 31, 2006, year-end. Registrant A files a Form S-4 on January 2, 2007, before filing its December 31, 2006, Form 10-K. Registrant A's Form S-4 may become effective including the executive compensation disclosures from its December 31, 2005, Form 10-K. However, if the Form S-4 also relates to a proxy solicitation that involves the election of directors or the approval of matters relating to executive or director compensation, the Form S-4 would be required to include or incorporate by reference the December 31, 2006, executive compensation disclosures before becoming effective.

Example 2

Registrant A has a December 31, 2006, year-end. Registrant A files a Form S-4 on March 15, 2007, after filing its December 31, 2006, Form 10-K on March 1, 2007. The Form 10-K did not include the required executive compensation disclosure. Thus, for the Form S-4 to be effective, Registrant A must either (1) file its proxy statement, which would include the executive compensation disclosures for the year ended December 31, 2006, prior to the Form S-4 being filed on March 15, 2007, or (2) update its Form 10-K to include the required executive compensation disclosures for the year ended December 31, 2006, prior to the Form S-4 being filed on March 15, 2007.

Alternatively, Registrant A could have filed a preliminary Form S-4 prior to filing either the proxy statement or the revised Form 10-K; however, the SEC would not declare the Form S-4 effective until the executive compensation information was filed.

Grant Date Fair Value of Equity Award With Performance Conditions in Grants of Plan-Based Awards Table (Item 402(d)(2)(viii) of Regulation S-K)

In December 2006, the SEC issued its interim final rules related to disclosure requirements for executive and director compensation. The rules require, among other items, a registrant to include a column in the Grants of Plan-Based Awards Table that reports the grant date fair value of all stock and option awards granted during the fiscal year. The rule states that the amount to be presented in the Table is "the grant date fair value of each equity award computed in accordance with [Statement 123(R)]."[15] Further, the amount should be presented without the effect of forfeitures.

Statement 123(R)[16] states, "Performance or service conditions that affect vesting are not reflected in estimating the fair value of an award at the grant date . . . ."[17] Accordingly, if a performance condition contained in a share-based payment award is not met, no compensation cost will be recognized for that award.

Question: The Regulations Committee asked the SEC staff whether the probability of the performance condition being attained would be ignored for purposes of preparing the Grants of Plan-Based Awards Table, similarly to the non-consideration of forfeitures in preparing the Table.

SEC Staff View: The SEC staff indicated that the fair value of the award is based on the **maximum** number of options that will vest. Therefore, forfeitures that have not occurred and other performance conditions that have not been met would not be considered in calculating the fair value of the award for purposes of disclosure in the Grants of Plan-Based Awards Table.

[15] FASB Statement No. 123(R), *Share-Based Payment*.
[16] Paragraph 48 of Statement 123(R).
[17] As noted in Statement 123(R), performance conditions in share-based payment awards are those targets that refer solely to an employer's own operations or activities, such as EPS, revenue, growth in revenue, attainment of regulatory approval, market share, or increase in market share.

Example

On March 19, 2007, the Board of Directors grants options to the CEO. The number of options that will vest is tied to EPS for the year ended March 31, 2009 as follows:

- If EPS is $3.00 or more, the CEO will vest in 20,000 options.
- If EPS is more than $2.50 but less than $3.00, the CEO will vest in 5,000 options.
- If EPS is less than $2.50, the CEO will vest in no options.

Regardless of the EPS target achieved, the strike price and term of the option are the same. At the grant date, the fair value of an option is $10.00. Management also believes it is probable that EPS for 2009 will be above $2.50 but will be less than $3.00. Accordingly, for accounting purposes, the amount of compensation expense for 2007 is being recognized on the basis of the CEO vesting in 5,000 options.

In accordance with the view taken by the SEC staff, the fair value of the award is based on the maximum number of options that could vest. Using the example, $200,000 (i.e., 20,000 options × $10.00 = $200,000) is reported in the Grants of Plan-Based Awards Table.

Application of Item 308T of Regulations S-K and S-B to a Non-Accelerated Filer That Early Adopts Internal Control Reporting by Management

As stated in the SEC's December 2006 final rule, *Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers and Newly Public Companies*,[18] a non-accelerated filer is not required to provide management's report on internal control over financial reporting (ICFR)[19] in its annual report until its first fiscal year ending on or after December 15, 2007. Further, a non-accelerated filer is not required to include an auditor's attestation report on ICFR from its independent registered public accounting firm on ICFR[20] in its annual report until its first fiscal year ending on or after December 15, 2008. These requirements were adopted in Regulation S-K, Item 308T,[21] a temporary provision to Item 308.

However, situations may arise in which a non-accelerated filer whose fiscal year ends before December 15, 2007, may wish to voluntarily furnish its management report on ICFR.

Question: The Regulations Committee asked the SEC staff if a non-accelerated filer that chooses to furnish its management report on ICFR for a fiscal year ending before December 15, 2007, would also not be required to obtain an attestation report from its independent registered public accounting firm on ICFR for the fiscal year that ends before December 15, 2007 (because it is subject to the temporary provisions of Item 308T).

SEC Staff View: The SEC staff noted that the temporary provisions of Item 308T do not technically apply to a fiscal year ending before December 15, 2007, and would therefore not be available to a non-accelerated filer that wanted to early adopt Section 404[22] reporting on ICFR for a fiscal year ending before December 15, 2007. However, the SEC staff expressed doubt that further action would be taken if a registrant furnished its management's report on ICFR without also filing an independent registered public accounting firm's report on ICFR.

Determining Accelerated Filer Status for a Company That Was Recently Spun-Off From an SEC Registrant-Parent (Update to Discussion Document C from the June 2004 Meeting)

As described in Discussion Document C from the June 2004 Regulations Committee meeting, the Regulations Committee and the SEC staff have previously discussed the determination of accelerated filer status of a subsidiary (Spinco) that was spun off from its parent company. At the June 2004 meeting, the SEC staff stated that Spinco should make its own determination of accelerated filer status, in accordance with Exchange Act Rule 12b-2,[23] rather than have the former parent's accelerated filer status be "pushed down" to Spinco. Further, it was noted

[18] Release 33-8760; 34-54942.
[19] As required by SEC Regulations S-K and S-B, Item 308(a).
[20] As required by SEC Regulations S-K and S-B, Item 308(b).
[21] SEC Regulation S-K and Regulation S-B, Item 308T, "Internal Control Over Financial Reporting."
[22] Sarbanes-Oxley Act of 2002, Section 404, "Management Assessment of Internal Controls."
[23] Securities Exchange Act of 1934, Rule 12b-2, "Definitions."

that although the former parent's reporting history might, under certain circumstances as described in SEC Staff Legal Bulletin No. 4, be considered by Spinco in determining its eligibility to use Form S-3, this accommodation should not be considered when determining whether Spinco meets the definition of an accelerated filer.

However, footnote 76 to the December 2006 final rules on internal control over financial reporting (Release 33-8760; 34-54942), indicates that there may be instances in which Spinco's status as an accelerated filer may be determined by the former parent's accelerated filer status.

Question: The Regulations Committee asked the SEC staff if Discussion Document C from the June 2004 meeting should be updated to reflect the views outlined in the December 2006 final rule.

SEC Staff View: The SEC staff noted that in some situations, Spinco may attempt to use its former parent's reporting history to meet the eligibility requirements of Form S-3 (as discussed in SEC Staff Legal Bulletin No. 4). Given the inter-relationship between Form S-3 eligibility and accelerated filer status, if Spinco seeks to use and is deemed eligible to use Form S-3 on the basis of the former parent's reporting history, Spinco would also be deemed an accelerated filer. Therefore, Spinco would be required to provide both management's report on ICFR and an auditor attestation report on ICFR[24] in its 2007 annual report (even though that report is its first annual report). If, however, Spinco did not seek to use its former parent's reporting history for purposes of meeting the eligibility requirements of Form S-3, then Spinco's evaluation of its status as an accelerated filer (and a newly public company) should be performed independently of its former parent and should be based on the criteria set forth in Exchange Act Rule 12b-2 and Release 33-8760. As a result, since this is Spinco's first annual report, Spinco would be exempt from the requirement to provide either management's report on ICFR or an auditor attestation report on ICFR.

Financial Statement Requirements in an IPO When a Merger of Entities Under Common Control Occurs at the Closing Date

In her speech at the 2006 AICPA National Conference on Current SEC and PCAOB Developments, Leslie Overton, associate chief accountant in the SEC's Division of Corporation Finance, addressed issues related to accounting and reporting for an IPO that occurs in connection with a merger of entities under common control (see Deloitte & Touche's December 21, 2006, *Heads Up* for further discussion). Ms. Overton's speech discussed the form and content of the financial statements that are required in the associated registration statement when the merger occurs (1) by the time of effectiveness of the IPO or (2) after effectiveness of the IPO. Ms. Overton stated that it would be appropriate to reflect the merger of the entities in the historical financial statements only if the merger occurs by the time of effectiveness of the IPO. Ms. Overton noted that if the merger were to occur after the effectiveness of the IPO, the separate historical financial statements of the entities to be combined should be presented, and the merger should only be reflected in the pro forma financial statements presented.

In addition, the Regulations Committee presumes that using combined financial statements as the denominator for purposes of significance calculations pursuant to rules such as Rule 3-05[25] and Rule 3-09[26] is likely to better serve investors, because this approach is less likely to trigger the need for unnecessary information that should be filtered out of registration statements.

Question: In situations in which the merger will occur after the effectiveness of an IPO or other similar transaction, but no later than closing of the IPO or other similar transaction, the Regulations Committee asked the SEC staff to confirm the acceptability of providing combined financial statements of entities under common control instead of separate historical financial statements of the entities to be combined. The combined financial statements would be presented along with pro forma financial statements.

SEC Staff View: The SEC staff asked for additional time to consider this issue. Until a view is articulated, the SEC

[24] In accordance with Items 308(a) and 308(b) of Regulation S-K (i.e., Sarbanes-Oxley Section 404 reporting).
[25] SEC Regulation S-X, Rule 3-05, "Financial Statements of Businesses Acquired or to Be Acquired."
[26] SEC Regulation S-X, Rule 3-09, "Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons."

staff encourages registrants with this fact pattern to consult with the SEC staff regarding the primary financial statement requirements in their particular facts and circumstances. The SEC staff also indicated that it would consider requests for relief to use combined financial amounts as the denominator in the significance calculations used to determine other financial statement requirements for the filing (e.g., Rules 3-05 and 3-09).

Application of Rules 3-09 and 4-08(g) of Regulation S-X to Investments Accounted for Using the Fair Value Option Under Statement of Financial Accounting Standards No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" That Otherwise Would Be Accounted for Under the Equity Method Under APB 18, "The Equity Method of Accounting for Investments in Common Stock"

Rules 3-09 and 4-08(g)[27] require registrants that have equity investments to present varying levels of financial information of the investee on the basis of the results of the tests of significance in Rule 1-02(w).[28] For the income test of significance, the numerator of the calculation is the registrant's equity in the pretax income of the investee. However, registrants that elect the fair value option for investments that would otherwise be accounted for under APB 18[29] would no longer record their share of the investee's income. Instead, the change in fair value of the investee would be recorded in the parent's pretax income.

Question: The Regulations Committee asked the SEC staff whether an equity method investment accounted for under the fair value option is still subject to the financial statement presentation requirements of Rules 3-09 and 4-08(g), and if so, how the income test should be performed.

SEC Staff View: The SEC staff asked for additional time to consider this issue.

[27] SEC Regulation S-X, Rule 4-08, "General Notes to Financial Statements."
[28] SEC Regulation S-X, Rule 1-02, "Definitions of Terms Used in Regulation S-X."
[29] APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*.

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