U.S. Securities and Exchange Commission

Speech by SEC Staff:
Remarks before the 2007 AICPA National Conference on Current SEC and PCAOB Developments

by

Steven C. Jacobs

Associate Chief Accountant, Division of Corporation Finance
U.S. Securities and Exchange Commission

Washington, D.C.
December 11, 2007

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

Good morning.

Pro Forma MD&A

Last year and at some conferences in the past, my colleagues have discussed issues related to predecessor financial statements and other circumstances in which a reporting company may have a change in basis during the periods presented. Another hot topic has been transparent and meaningful disclosure in MD&A. Since this is my first time speaking before this audience, I thought I would play it safe here and combine two known crowd pleasers.

The requirements of Item 303 of Regulation S-K are clear. For the purposes of discussing its results of operations, a registrant must cover the three-year period covered by the financial statements (two years in the case of a smaller reporting company) and use year-to-year comparisons to enhance a reader's understanding. The analysis must be of the financial statements included in the filing.

That being said, we acknowledge there may be situations where comparisons other than those of the historical financial information may provide valuable supplemental and in certain cases, more relevant analyses, to fully discuss trends and changes. For example, a registrant may consummate a large

business acquisition during the period that impacts the comparability of the most recent year's results to the prior year. In another example, a registrant may have applied push-down accounting due to a change in control in a reporting period through the application of EITF D-97 or where a NEWCO with no substantive operations acquires an operating company in a leveraged buyout transaction accounted for under EITF 88-16.

When determining whether a supplemental discussion based upon pro forma information should be included, registrants should consider all of the facts and circumstances surrounding the transaction, the nature of the pro forma adjustments to be made, and the overall meaningfulness of any such supplemental pro forma discussion. If it is determined that a supplemental discussion in MD&A based on pro forma financial information is appropriate and enhances the discussion, then the pro forma financial information should be prepared in accordance with Article 11 of S-X and should reflect the impact of only the transaction that has had the significant impact on comparability. Where the pre- and post-transaction periods are separately presented in the historical financial statements, it would be inappropriate to merely combine information for those periods without reflecting all relevant pro forma adjustments required by Article 11 of S-X.

A discussion based upon pro forma financial statements should only be prepared for the fiscal year preceding the date of the transaction and subsequent interim period. However, we would not object to a pro forma for the comparative interim period if appropriate to facilitate the comparison. It would be acceptable to then carry this supplemental discussion to subsequent periodic reports in which it may still be relevant. Once the effects of the transaction are reported in historical financial statements for a full year, then the MD&A should be based upon the historical financial statements only from that point forward. While this discussion should only be a supplement to the discussion of the audited financial statements, the staff would not object to a more robust pro forma analysis when it is necessary to highlight trends on a comparable basis.

Disclosure should be provided to explain how the pro forma presentation was derived, why management believes the presentation to be useful, and any potential risks associated with using such a presentation. Typically the presentation of a complete set of pro forma financial statements (in other words, one that reflects the adjustments) will be necessary in order to facilitate an understanding of the basis of the information being discussed unless those same statements are already included in the filing.

Section 404 Implementation Issues

Next, I would like to discuss some issues related to Section 404, which had a big year in 2007. Not only did the Commission approve Management's Guidance and AS5, but this year is the first one in which the management of nonaccelerated filers will have to assess their internal controls over financial reporting. Nonaccelerated filers with calendar year-ends will be required to take their first reporting step towards full compliance with Section 404 of the

Sarbanes-Oxley Act. For the upcoming year-end, nonaccelerated filers will be furnishing management's report on internal controls over financial reporting. In the following year, those reports will need to "filed" and accompanied by an auditors' attestation report.

With this impending milestone, has come an array of questions, primarily related to scope and application. Some of these may have been asked in the past by accelerated filers, but the increased volume of companies currently implementing Section 404 has given them more attention. We generally have been requesting that registrants write into the Division with certain of these questions, especially those related to obtaining any relief, since such questions are based upon individual facts and circumstances. The purpose of this speech is not to provide bright lines to be used in making these determinations or to put any parameters on the substance of your submission. Instead, I would like to share some thoughts you might consider when seeking any relief on these matters.

In December 2006, the Commissioners approved a rule granting newly-public companies a one-year transition period before being subject to the internal control over financial reporting requirements. The release amended Item 308 of Regulation S-K to say that a registrant need not assess its internal controls over financial reporting "until it either had been required to file an annual report pursuant to section 13(a) or 15(d) of the Exchange Act for the prior fiscal year or had filed an annual report with the Commission for the prior fiscal year." Related to that release, many have asked permission to extend the relief granted to newly public companies to situations they deem to be similar. For example, it is common for a private operating company to be recapitalized into a non-operating pubic shell company during the shell company's fiscal year. While the historical financial reporting for pre-transaction periods may change to that of the operating company once the transaction has occurred, we do not believe the legal issuer has changed in this transaction. Therefore, we do not believe the December 2006 release applies to operating companies participating in these transactions, and as such we do not consider them to be newly-public companies.

However, we do acknowledge that any internal controls of the shell company generally cease to exist prior to the end of the year in which the transaction occurred and in some cases it just may not be possible for an operating company to effectively and efficiently complete an assessment of its internal controls for the year in which the transaction is consummated. These determinations are often based upon facts and circumstances; therefore, it is difficult to draw a bright line as to when those assessments can be completed. You may recall that Louise Dorsey spoke last year about the updating requirements for the operating company in these types of transactions that may require financial statements, MD&A, and related information akin to what is included in an annual report to be filed on an amended Form 8-K so as to prevent any gaps in reporting periods. I think that it would be unusual to reach a conclusion that completing the assessment is not possible in its first Form 10-K, if the operating company already has filed the equivalent of an annual report in an amended Form 8-K for the prior year.

To twist this example a little bit, we have also been asked what type of relief is available in the situation where two operating companies consummate a reverse merger. These situations can be more complex, and reaching an appropriate conclusion may require consideration of the timing of the transaction, the terms of the transaction, and how and when changes will occur in the merged entity subsequent to the acquisition.

We have seen two questions related to these transactions. First, "Can we exclude the legal acquiree or accounting acquirer from our assessment?" Second, "if we don't have to test controls for the accounting acquirer, can we get relief from performing an assessment altogether?" To me, these should really come down to questions related to practicability and relevance. In other words, is there any piece of the assessment that is impracticable? And would the conclusions related to the assessment I am able to perform be meaningful and relevant to investors? Said another way, could the report I am able and intend to provide be misleading in some way?

As you probably know, the third question on the Frequently Asked Questions document updated by the staff this past September permits exclusion of internal controls related to acquired businesses from the scope of management's assessment in the first Form 10-K following a material business combination. A recent external study determined that about 11% of those companies completing management's assessment in the past year relied on the relief in FAQ#3. After looking at the disclosures for the largest 50 of those companies, we noticed that 17 of them had scoped out entities that were acquired in the first quarter of their fiscal year, about half of which were consummated in the first month of their fiscal year. Since FAQ#3 is a key component in this discussion, I would like to take this opportunity to remind everyone that consideration of the staff's response requires judgment. Specifically, the document says that we "typically expect management's report on internal control over financial reporting to include controls at all consolidated entities." That being said, we understand that it may not be possible to assess the internal controls related to a recently acquired business if there is not adequate time between the consummation date and the assessment date. In these cases, management should use its judgment in making the determination as to whether it is possible to complete an effective assessment of the target in light of the timing. If an assessment of the target is clearly possible considering timing and other circumstances, it may be difficult to understand how users are best served by excluding it.

Returning to our reverse merger situation, I do not believe the staff contemplated reverse mergers when responding to Question 3. However, analogizing to that response, we do acknowledge that there may not always be adequate time to complete an assessment of the accounting acquirer's internal controls between the consummation date and the assessment date. In those situations, we could understand that completing the assessment related to the accounting acquirer may be impracticable. Similar to the public shell merger example given earlier in my speech, the earlier in the year in which the transaction is consummated, the more practicable an assessment

may be.

To the second question regarding full blown relief, one must ask whether any meaningful assessment of what is left over can be done. There are many factors and indicators for a registrant to consider when making that determination. Again, timing becomes an issue. If the transaction occurs early in the year, there may be enough time to fully integrate controls and processes and complete an assessment of the merged entity's internal controls. However, if the transaction occurs late in the year, it still seems that a meaningful assessment of the legal acquirer's internal controls may be possible. In some mergers, plans to integrate companies may just begin to be formed at the time the merger is consummated and actual integration of employees, systems, processes, and therefore, internal controls may not occur for months. In these cases, it seems likely that the internal controls over financial reporting for the legal acquirer or issuer would still be in place as of the assessment date and an issuer would be able to conduct an assessment of its internal controls even if it were to exclude the internal controls of the accounting acquirer. This would seem even more likely if management of the legal acquirer stayed on board after the transaction closed leaving entity level controls generally intact as well. For argument's sake, I would like to highlight that the accounting treatment generally does not have any direct impact on the internal control environment and systems in a merger of similar sized entities. Had the transaction not been accounted for as a reverse merger, we would certainly require an assessment of the issuer allowing them to look to FAQ #3 for the target. Said more clearly, it should not solely be the accounting treatment for the merger that impacts a registrant's ability to conduct an assessment of internal controls.

Well, the next question would become, "is an assessment of only the legal acquirer even meaningful when looking at the financial statements included in the filing?" Some may claim that an assessment for just the legal acquirer would not be meaningful in a transaction that closed near year-end because only a short period of its operations are included in the consolidated financial statements. Again, there are no bright lines here and one must consider what share of consolidated revenues, expenses, income, and any other key operating measures would be deemed to be insignificant so that an assessment at just that level would not be meaningful when considered with the consolidated financial statements as a whole. However, it is important that registrants also consider the significance to the balance sheet. In a merger of similar sized entities, it may be difficult to make the case that the legal acquirer's assets and liabilities, considering any step up in bases, are insignificant to the financial statements so as to render an assessment of only the legal acquirer meaningless.

Are there any situations other than reverse mergers where applying the existing guidance may not result in a meaningful assessment of internal controls effectiveness? The only circumstances we have seen have been limited to Special-Purpose Acquisition Companies or SPACs. SPACs, which have become popular in the past few years, are companies with no operations formed by sponsors who then raise capital with the intent of acquiring an operating company. For the most part, these companies have no

true operations until they complete a business combination. Until the business combination is completed, the SPAC has the same requirements related to Section 404 as any other issuer. In many cases, the SPAC purchases a business with cash or a combination of cash and stock, and the transaction is accounted for as business combination under SFAS 141. These business combinations are not substantively different from those contemplated by FAQ #3, so it would seem logical that a SPAC would be able to consider the FAQ when contemplating excluding the target from its assessment of internal controls. However, in many cases the internal controls and processes of the operating company or target are the only ones remaining after such a transaction. In other words, if the company were to apply the FAQ, there would really be no meaningful controls to assess as of year-end. In such cases and depending on the facts and circumstances as a whole, such as the timing of the transaction, the staff may not object to excluding management's report on internal controls from the Form 10-K entirely.

In rare cases, the question has come up whether there are similar scope-outs such as those in FAQ #3 related to disclosure controls and procedures. In these cases, we have told companies that they can only exclude those disclosure controls and procedures that are also considered internal controls over financial reporting.

This brings me to my last point which is disclosure...As you should now be able to tell these evaluations and conclusions can easily become complex. For this reason, it is extremely important that companies provide transparent disclosure as to any entities that have been excluded from the assessment and the significance of those entities to the consolidated financial statements. Other than the "newly public companies" by rule, an assessment of internal controls over financial reporting is required for all companies who file annual reports with the SEC. If the company has not performed an assessment because they are a new public company, it is important that they provide the disclosure required in Item 308 of Regulation S-K. If they have not performed an assessment for any other reasons such as those described in this speech, we recommend that companies describe the transactions, tell readers why the assessment was not practicable and/or meaningful, and explain what they are doing to prepare for the following year. If an assessment is not being performed because of significant changes in the internal controls following a reverse merger of two operating companies, companies should provide transparent disclosure to summarize those changes with the intent of providing a more complete understanding of why an assessment was not performed. They are also required to include the language related to the design of their internal controls over financial reporting in the Section 302 certifications.

With that, we look forward to hearing from you on these issues as appropriate. I will now turn it over to Todd Hardiman. Thank you for your time this morning.

See also: Slide presentation (PDF)

http://www.sec.gov/news/speech/2007/spch121107scj.htm

 Modified: 12/12/2007