

SCIENTIFIC GAMES CORP
Form 10-Q
August 06, 2014

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

✓ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2014

OR
“ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

Commission file number: 0-13063
SCIENTIFIC GAMES CORPORATION
(Exact name of registrant as specified in its charter)
Delaware
(State or other jurisdiction of
incorporation or organization)

81-0422894
(I.R.S. Employer Identification No.)

750 Lexington Avenue, New York, New York 10022
(Address of principal executive offices)
(Zip Code)

(212) 754-2233
(Registrant’s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer

Non-accelerated filer Smaller reporting company

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes No

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

The registrant has the following number of shares outstanding of each of the registrant's classes of common stock as of August 1, 2014:

Class A Common Stock: 84,649,405

Class B Common Stock: None

SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES
INDEX TO FINANCIAL INFORMATION
AND OTHER INFORMATION
THREE AND SIX MONTHS ENDED JUNE 30, 2014

	Page
<u>PART I.</u>	<u>6</u>
<u>FINANCIAL INFORMATION</u>	
Item 1.	6
Financial Statements	
	6
Consolidated Statements of Operations and Comprehensive Loss for the Three and Six Months Ended June 30, 2014 and 2013	
	8
Consolidated Balance Sheets as of June 30, 2014 and December 31, 2013	
	9
Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2014 and 2013	
	10
Notes to Consolidated Financial Statements	
Item 2.	45
Management’s Discussion and Analysis of Financial Condition and Results of Operations	
Item 3.	68
Quantitative and Qualitative Disclosures About Market Risk	
Item 4.	68
Controls and Procedures	
PART II.	69
OTHER INFORMATION	
Item 1.	69
Legal Proceedings	
Item 1A.	71
Risk Factors	
Item 2.	72
Unregistered Sales of Equity Securities and Use of Proceeds	
Item 3.	73
Defaults Upon Senior Securities	
Item 4.	73
Mine Safety Disclosures	
Item 5.	73
Other Information	
Item 6.	74
Exhibits	

Glossary of Terms

As used in this Quarterly Report on Form 10-Q, the terms "we," "us," "our" and the "Company" mean Scientific Games Corporation and its consolidated subsidiaries. The following terms or acronyms used in this Form 10-Q are defined below:

Term or Acronym	Definition
2018 Notes	8.125% senior subordinated notes due 2018 issued by Scientific Games Corporation
2019 Notes	9.250% senior subordinated notes due 2019 issued by SGI
2020 Notes	6.250% senior subordinated notes due 2020 issued by SGI
2021 Notes	6.625% senior subordinated notes due 2021 issued by SGI
ASC	Accounting Standards Codification
ASU	Accounting Standards Update
Barcrest	Barcrest Group Limited, an indirect wholly owned subsidiary of Scientific Games Corporation
China Loans	RMB denominated loans due 2014
CSG	Beijing CITIC Scientific Games Technology Co., Ltd., the instant games supplier to the CSL, in which we have a 49% equity interest
CSL	China Sports Lottery
D&A	depreciation and amortization expense
ESPP	Employee Stock Purchase Plan
FASB	Financial Accounting Standards Board
Global Draw	The Global Draw Limited, an indirect wholly owned subsidiary of Scientific Games Corporation
GLB	Beijing Guard Libang Technology Co., Ltd., a provider of lottery systems and services to the China Welfare Lottery, in which we have a 50% equity interest
Hellenic Lotteries	Hellenic Lotteries S.A., the operator of the Greek state lotteries, in which we have a 16.5% equity interest
ITL	International Terminal Leasing, an entity that leases gaming machines to us for provision to our customers, in which we have a 50% equity interest
LAP	local-area progressive
LBO	licensed betting office
LNS	Lotterie Nazionali S.r.l., the operator of the Gratta e Vinci instant ticket lottery in Italy, in which we have a 20% equity interest
MD&A	Management's discussion and analysis of financial condition and results of operations
Northstar Illinois	Northstar Lottery Group, LLC, the private manager of the Illinois lottery, in which we have a 20% equity interest
Northstar New Jersey	Northstar New Jersey Lottery Group, LLC, the operating entity that provides marketing and sales services to the New Jersey lottery, in which we have a 17.69% equity interest
Note	refers to a note to our Consolidated Financial Statements, unless otherwise specified
participation	with respect to our lottery business, refers to a contract or arrangement in which we are paid based on a percentage of retail sales
PMA	private management agreement
Provoloto	SG Provoloto, S. de R.L. de C.V., an indirect wholly owned subsidiary of Scientific Games Corporation until February 2014
R&D	research and development expense
RCN	Roberts Communications Network, LLC, a provider of communications services to racing and other customers, in which we have a 29.4% equity interest
RMB	Chinese Renminbi Yuan
RSU	restricted stock unit
SEC	Securities and Exchange Commission

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

SG&A	selling, general and administrative expense
SGI	Scientific Games International, Inc., a direct wholly owned subsidiary of Scientific Games Corporation
Sportech	Sportech plc, an operator and supplier of sports pools and tote systems, in which we had a 20% equity interest until January 2014
U.S.	United States of America
U.S. GAAP	accounting principles generally accepted in the United States of America
VLT	video lottery terminal
WAP	wide-area progressive
WMS	WMS Industries Inc., a direct wholly owned subsidiary of Scientific Games Corporation

Forward-Looking Statements

Throughout this Quarterly Report on Form 10-Q, we make "forward-looking statements" within the meaning of the U.S. Private Securities Litigation Reform Act of 1995. Forward-looking statements describe future expectations, plans, results or strategies and can often be identified by the use of terminology such as "may," "will," "estimate," "intend," "continue," "believe," "expect," "anticipate," "should," "could," "potential," "opportunity," or similar terminology. The forward-looking statements contained in this Quarterly Report on Form 10-Q are generally located under the heading "Management's Discussion and Analysis of Financial Condition and Results of Operations" but may be found in other locations as well. These statements are based upon management's current expectations, assumptions and estimates and are not guarantees of future results or performance. Actual results may differ materially from those contemplated in these statements due to a variety of risks and uncertainties and other factors, including, among other things:

- competition;
- U.S. and international economic and industry conditions, including declines in or slow growth of lottery retail sales or gross gaming revenues and reductions in or constraints on capital spending by gaming or lottery operators;
- slow growth of new gaming jurisdictions, slow addition of casinos in existing jurisdictions and declines in the replacement cycle of gaming machines;
- ownership changes and consolidation in the casino industry;
- opposition to legalized gaming or the expansion thereof;
- inability to adapt to, and offer products that keep pace with, evolving technology;
- inability to develop successful gaming concepts and content;
- laws and government regulation, including those relating to gaming licenses and environmental laws;
- inability to identify and capitalize on trends and changes in the lottery and gaming industries, including the expansion of interactive gaming;
- dependence upon key providers in our social gaming business;
- inability to retain or renew existing contracts or enter into new contracts, or less favorable modifications to existing contracts;
- level of our indebtedness, unavailability or inadequacy of cash flows to satisfy obligations or future needs, and restrictions and covenants in our debt agreements;
- protection of our intellectual property, ability to license third party intellectual property and the intellectual property rights of others;
- security and integrity of our software and systems and reliance on or failures in our information technology systems;
- natural events that disrupt our operations or those of our customers, suppliers or regulators;
- inability to benefit from, and risks associated with, strategic equity investments and relationships, including (1) the inability of our joint venture to meet the net income targets or otherwise to realize the anticipated benefits under its PMA with the Illinois Lottery, (2) the inability of our joint venture to meet the net income targets or other requirements under its agreement to provide marketing and sales services to the New Jersey Lottery or otherwise to realize the anticipated benefits under such agreement (including as a result of a protest) and (3) failure to realize the anticipated benefits related to the award to our consortium of an instant lottery game concession in Greece;
- failure to achieve the intended benefits of the WMS acquisition, including due to the inability to realize synergies in the anticipated amounts or within the contemplated time-frames or cost expectations, or at all;
- inability to complete and integrate future acquisitions, including the pending acquisition of Bally Technologies, Inc. ("Bally") due to the failure to obtain the required approvals or debt financing or otherwise;
- litigation related to the pending Bally acquisition;
- disruption of our current plans and operations as a result of the pending Bally acquisition;
- costs, charges and expenses related to the pending Bally acquisition;
-

failure to realize the intended benefits of the pending Bally acquisition, including the inability to realize the anticipated synergies in the expected amount or within the anticipated time frames or cost expectations or at all;
incurrence of restructuring costs and impairment charges and compliance with revenue recognition standards
fluctuations in our results due to seasonality and other factors;
dependence on suppliers and manufacturers;
risks relating to foreign operations, including fluctuations in foreign currency exchange rates and restrictions on the import of our products;
dependence on our employees;
litigation and other liabilities relating to our business, including litigation and liabilities relating to our contracts and licenses, our products and systems, our employees, intellectual property and our strategic relationships;
influence of certain stockholders; and
stock price volatility.

Additional information regarding risks and uncertainties and other factors that could cause actual results to differ materially from those contemplated in forward-looking statements is included from time to time in our filings with the SEC, including under the heading “Risk Factors” in our most recent Annual Report on Form 10-K. Forward-looking statements speak only as of the date they are made and, except for our ongoing obligations under the U.S. federal securities laws, we undertake no obligation to publicly update any forward-looking statements whether as a result of new information, future events or otherwise.

This Quarterly Report on Form 10-Q may contain references to industry market data and certain industry forecasts. Industry market data and industry forecasts are obtained from publicly available information and industry publications. Industry publications generally state that the information contained therein has been obtained from sources believed to be reliable, but that the accuracy and completeness of that information is not guaranteed. Although we believe industry information to be accurate, it is not independently verified by us and we do not make any representation as to the accuracy of that information. In general, we believe there is less publicly available information concerning the international lottery and gaming industries than the lottery and gaming industries in the U.S.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS

(Unaudited, in millions, except per share amounts)

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2014	2013	2014	2013
Revenue:				
Instant games	\$135.4	\$126.5	\$261.6	\$249.3
Services	179.3	85.2	356.1	167.0
Product sales	102.2	23.3	187.3	38.3
Total revenue	416.9	235.0	805.0	454.6
Operating expenses:				
Cost of instant games (1)	72.9	71.5	142.8	139.7
Cost of services (1)	64.6	46.2	131.1	92.4
Cost of product sales (1)	54.9	15.7	101.3	26.0
Selling, general and administrative	95.2	44.7	187.0	93.5
Research and development	24.8	1.4	50.7	3.3
Employee termination and restructuring	4.9	—	10.5	0.3
Depreciation and amortization	96.0	43.1	190.1	75.9
Operating income (loss)	3.6	12.4	(8.5)	) 23.5
Other income (expense):				
Interest expense	(49.3)	) (25.1)	) (97.2)	) (50.1)
Earnings from equity investments	0.7	3.5	6.2	9.6
Loss on early extinguishment of debt	(25.9)	) —	(25.9)) —
Gain on sale of equity interest	—	—	14.5	—
Other income (expense), net	3.2	0.2	6.1	(0.8)
Total other expense	(71.3)	) (21.4)	) (96.3)	) (41.3)
Net loss from continuing operations before income taxes	(67.7)	) (9.0)	) (104.8)	) (17.8)
Income tax expense	(4.7)	) (3.4)	) (12.6)	) (6.9)
Net loss from continuing operations	\$(72.4)	) \$(12.4)	) \$(117.4)	) \$(24.7)
Discontinued operations:				
Loss from discontinued operations	—	(0.7)	) —	(2.6)
Other expense	—	0.1	—	—
Gain on sale of assets	—	—	—	0.8
Income tax benefit	—	—	—	0.3
Net loss from discontinued operations	\$—	) \$(0.6)	) \$—	) \$(1.5)
Net loss	\$(72.4)	) \$(13.0)	) \$(117.4)	) \$(26.2)
Other comprehensive income (loss):				
Foreign currency translation gain (loss)	10.0	0.6	10.1	(38.7)
Pension and post-retirement (loss) gain, net of tax	(0.2)	) 0.2	(0.1)	) 0.7
Derivative financial instruments unrealized (loss) gain, net of tax	(5.6)	) —	(6.3)	) 0.7
Other comprehensive income (loss)	4.2	0.8	3.7	(37.3)
Comprehensive loss	\$(68.2)	) \$(12.2)	) \$(113.7)	) \$(63.5)

(1) Exclusive of depreciation and amortization.

6

SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS (cont'd)
(Unaudited, in millions, except per share amounts)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Basic net loss per share:				
Continuing operations	\$(0.86)	\$(0.14)	\$(1.39)	\$(0.29)
Discontinued operations	—	(0.01)	—	(0.02)
Total basic net loss per share	\$(0.86)	\$(0.15)	\$(1.39)	\$(0.31)
Diluted net loss per share:				
Continuing operations	\$(0.86)	\$(0.14)	\$(1.39)	\$(0.29)
Discontinued operations	—	(0.01)	—	(0.02)
Total diluted net loss per share	\$(0.86)	\$(0.15)	\$(1.39)	\$(0.31)
Weighted average number of shares used in per share calculations:				
Basic shares	84.4	85.0	84.4	84.8
Diluted shares	84.4	85.0	84.4	84.8

See accompanying notes to consolidated financial statements.

SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

(in millions, except par value)

	June 30, 2014	December 31, 2013
ASSETS	(Unaudited)	
Current assets:		
Cash and cash equivalents	\$89.2	\$153.7
Restricted cash	11.8	10.9
Accounts receivable, net	326.5	346.0
Notes receivable, net	135.0	158.7
Inventories	170.3	137.8
Deferred income taxes, current portion	35.1	35.1
Prepaid expenses, deposits and other current assets	111.3	119.3
Total current assets	879.2	961.5
Property and equipment, net	766.8	772.6
Long-term notes receivable	56.4	72.6
Goodwill	1,197.8	1,186.9
Intangible assets, net	510.3	411.1
Software, net	321.1	343.5
Equity investments	329.7	367.2
Other assets	122.2	126.5
Total assets	\$4,183.5	\$4,241.9
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Debt payments due within one year	\$36.2	\$30.4
Accounts payable	83.9	140.9
Accrued liabilities	280.1	285.8
Total current liabilities	400.2	457.1
Deferred income taxes	146.1	138.0
Other long-term liabilities	223.8	109.6
Long-term debt, excluding current installments	3,187.5	3,162.2
Total liabilities	3,957.6	3,866.9
Commitments and contingencies		
Stockholders' equity:		
Class A common stock, par value \$0.01 per share: 199.3 shares authorized; 101.8 and 100.4 shares issued and 84.6 and 85.2 shares outstanding, respectively	1.0	1.0
Additional paid-in capital	731.9	737.8
Accumulated loss	(353.8)	) (236.4)
Treasury stock, at cost: 17.2 and 15.2 shares held, respectively	(175.2)	) (145.7)
Accumulated other comprehensive income	22.0	18.3
Total stockholders' equity	225.9	375.0
Total liabilities and stockholders' equity	\$4,183.5	\$4,241.9

See accompanying notes to consolidated financial statements.

SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited, in millions)

	Six Months Ended	
	June 30,	
	2014	2013
Cash flows from operating activities:		
Net loss	\$(117.4	) \$(26.2
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	190.1	76.4
Change in deferred income taxes	1.9	1.5
Stock-based compensation	13.4	11.5
Non-cash interest expense	8.6	3.4
Earnings from equity investments, net	(6.2	) (9.6
Distributed earnings from equity investments	21.2	28.3
Loss on early extinguishment of debt	25.9	—
Gain on sale of equity interest	(14.5) —
Changes in current assets and liabilities, net of effects of acquisitions:		
Accounts and notes receivable	60.9	17.1
Inventories	(30.2	) 1.1
Accounts payable	(48.6	) (16.2
Accrued liabilities	(4.1	) (15.1
Other current assets and liabilities	9.2	1.1
Other	(3.1	) (3.3
Net cash provided by operating activities	107.1	70.0
Cash flows from investing activities:		
Additions to property and equipment	(21.1	) (15.0
Lottery and gaming services expenditures	(44.8	) (43.1
Intangible assets and software expenditures	(48.8	) (22.4
Proceeds from asset disposals	—	0.9
Change in other assets and liabilities, net	(0.2	) (0.2
Additions to equity method investments	(40.6	) (21.4
Distributions of capital on equity investments	32.9	16.3
Proceeds from sale of equity interest	44.9	—
Restricted cash	(0.9	) 1.3
Business acquisitions, net of cash acquired	—	(0.4
Net cash used in investing activities	(78.6	) (84.0
Cash flows from financing activities:		
Proceeds from the issuance of long-term debt	347.9	2.6
Payments on long-term debt	(364.7	) (11.7
Payments of financing fees	(22.8	) (2.0
Common stock repurchases	(29.5) —
Contingent earnout payments	(3.2) —
Net redemptions of common stock under stock-based compensation plans	(19.2	) (2.8
Net cash used in financing activities	(91.5	) (13.9
Effect of exchange rate changes on cash and cash equivalents	(1.5	) (3.0
Decrease in cash and cash equivalents	(64.5	) (30.9
Cash and cash equivalents, beginning of period	153.7	109.0

Cash and cash equivalents, end of period	\$89.2	\$78.1
--	--------	--------

See accompanying notes to consolidated financial statements.

SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited, table amounts in millions, except per share amounts)

(1) Description of the Business and Summary of Significant Accounting Policies

Description of the Business

We are a leading diversified supplier of technology-based products and services to the gaming and lottery industries. Our portfolio includes instant and draw-based lottery games; gaming machines and game content; server-based lottery and gaming systems; sports betting technology; loyalty and rewards programs; and interactive products and services. As a result of our acquisition of WMS in October 2013, we have significantly expanded our global gaming business.

Basis of Presentation and Principles of Consolidation

The accompanying consolidated financial statements of the Company have been prepared in accordance with SEC and U.S. GAAP requirements. All monetary values set forth in these financial statements are in U.S. dollars ("\$\$") unless otherwise stated herein. The accompanying consolidated financial statements include the Company's accounts and subsidiaries that are wholly owned and in which we have a controlling financial interest. Investments in other entities in which we do not have a controlling financial interest but we exert significant influence are accounted for in the consolidated financial statements using the equity method of accounting. All intercompany balances and transactions have been eliminated in consolidation. We have evaluated subsequent events through the date of these financial statements. In the opinion of management, we have made all adjustments necessary to present fairly our consolidated financial position, results of operations, comprehensive loss and cash flows for the periods presented. Such adjustments are of a normal, recurring nature. These consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in our 2013 Annual Report on Form 10-K. Interim results of operations are not necessarily indicative of results of operations for a full year.

In our Consolidated Statements of Operations and Comprehensive Loss for the three and six months ended June 30, 2013, we reclassified \$1.4 million and \$3.3 million, respectively, of R&D expense previously included within SG&A to conform to the current-year presentation.

On March 25, 2013, we completed the sale of our installed base of gaming machines in our pub business as discussed in Note 3 (Acquisitions and Dispositions) to this Quarterly Report on Form 10-Q. The results of the discontinued pub operations for the three and six months ended June 30, 2013 are presented herein in accordance with ASC 205, Presentation of Financial Statements - Discontinued Operations. There were no results of operations for this business for the three or six months ended June 30, 2014.

Significant Accounting Policies

There have been no changes to our significant accounting policies described in Note 1 in our 2013 Annual Report on Form 10-K except for the addition of our lease accounting policy as described below.

Lease Accounting

We account for assets held under lease in accordance with ASC 840, Leases. For leases classified as operating leases, we record expense on a straight-line basis over the base term of the lease agreements. For assets accounted for as capital leases, we record the lower of the net present value of the future minimum lease payments or the fair value of the leased asset at the inception of the lease. Amortization expense is computed using the straight-line method over the shorter of the estimated useful lives of the asset or the period of the related lease.

Recently Issued Accounting Guidance

In January 2014, the FASB issued ASU 2014-05, Service Concession Arrangements (Topic 853), a consensus of the FASB Emerging Issues Task Force, which specified that an operating entity should not account for a service concession arrangement within the scope of the update as a lease in accordance with ASC 840, Leases. The guidance is effective for fiscal years beginning after December 15, 2014. We do not expect ASU 2014-05 to have a material effect on our financial condition, results of operations or cash flows.

In April 2014, the FASB issued ASU 2014-08, Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity. ASU 2014-08 changes the criteria for reporting discontinued operations and modifies related disclosure requirements. The new guidance is effective on a prospective basis for fiscal years beginning after December 15, 2014, and interim periods thereafter. We do not expect ASU 2014-08 to have a material effect on our financial condition, results of operations or cash flows.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers. The amended guidance outlines a single comprehensive revenue model for entities to use in accounting for revenue arising from contracts with customers. The guidance supersedes most current revenue recognition guidance, including industry-specific guidance. The core principle of the revenue model is that “an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.” ASU 2014-09 is effective for fiscal years, and interim reporting periods within those years, beginning after December 15, 2016 (early adoption is not permitted). The Company is currently evaluating the impact of adopting ASU 2014-09.

In June 2014, the FASB issued ASU No. 2014-12, Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period. ASU 2014-12 requires that a performance target that affects vesting and could be achieved after the requisite service period be treated as a performance condition. A reporting entity should apply existing guidance in ASC 718, Compensation—Stock Compensation, as it relates to such awards. ASU 2014-12 is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2015 with early adoption permitted using either of two methods: (i) prospective to all awards granted or modified after the effective date; or (ii) retrospective to all awards with performance targets that are outstanding as of the beginning of the earliest annual period presented in the financial statements and to