

Heads Up

In This Issue

- Background
- Financial Statements of Businesses Acquired or to Be Acquired and Related Requirements
- Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons
- Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered
- Financial Statements of Affiliates Whose Securities Collateralize an Issue Registered or Being Registered
- Other Matters

Say It Loud, Say It Clear

SEC Seeks Input on Regulation S-X and Required Financial Information About Certain Entities Other Than the Registrant

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The SEC recently issued a [release](#) that requests public comment on the effectiveness of the financial disclosure requirements in Regulation S-X that apply to certain entities other than the registrant. The publication is the first request for comment associated with the Commission's [disclosure effectiveness initiative](#), a broad-based staff review of the disclosure requirements in the SEC's rules as well as the presentation and delivery of those disclosures. SEC Chairman Mary Jo White indicated that the request for comment is an "important step in our review of the disclosure requirements" and will "help us evaluate potential changes to Regulation S-X that would benefit both investors and companies."¹

Entities other than the registrant whose financial information may need to be disclosed may include acquired businesses, equity method investees, guarantors and issuers of guaranteed securities, and affiliates whose securities collateralize registered securities. The request for comment includes 58 questions about the disclosure requirements; the overall themes of these questions can be characterized as follows:

- How well do the requirements of each rule inform investors, and how do investors use the disclosures to make investment and voting decisions?
- What challenges do companies face in satisfying the requirements?
- What changes should be made to the requirements?

Comments on the release are due by November 30, 2015.

Editor's Note: Deloitte is interested in hearing directly from preparers, investors, and users regarding the broad range of questions in the request for comment. Please consider completing a [survey](#)² designed as a mechanism for gathering feedback on how to apply the rules, the usefulness of the required disclosures for investors, and suggested improvements to the requirements. The survey will stay open until October 20, 2015.

¹ Quoted from the SEC's September 25, 2015, [press release](#) announcing the request for comment.

² <https://deloittesurvey.deloitte.com/Community/se.ashx?s=3FC11B2622F407BC>.

Background

The request for comment primarily focuses on the following Regulation S-X rules:

- Rule 3-05, “Financial Statements of Businesses Acquired or to Be Acquired” (and related requirements).
- Rule 3-09, “Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons.”
- Rule 3-10, “Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered.”
- Rule 3-16, “Financial Statements of Affiliates Whose Securities Collateralize an Issue Registered or Being Registered.”

Editor’s Note: For more information about the above Regulation S-X rules, see the “SEC Reporting” section of Deloitte’s *SEC Comment Letters — Including Industry Insights: A Recap of Recent Trends*.

Financial Statements of Businesses Acquired or to Be Acquired and Related Requirements

Under Regulation S-X, when an SEC registrant consummates a significant business acquisition, the registrant may be required to file up to three years of the acquired business’s preacquisition audited annual financial statements and unaudited interim financial statements. If required, the financial statements of the acquired business are typically filed in a Form 8-K along with pro forma financial information.³ Additional requirements must be considered for probable acquisitions and for certain registration statements and proxy statements.

Disclosures about business acquisitions allow current and prospective investors to evaluate the future impact of an acquisition on the registrant’s financial condition, results of operations, liquidity, and future prospects. The SEC is seeking input on how investors use the information about a significant business acquisition and whether enhanced pro forma information can be more useful to investors. For example, the SEC is considering whether comparative pro forma income statements or additional disclosures would improve the usefulness of the pro forma financial information. The Commission is also requesting feedback on the income, investment, and asset tests that are performed to determine the significance of a business acquisition.⁴ Currently, these tests employ bright-line percentage thresholds⁵ and do not allow registrants to use judgment when evaluating the related facts and circumstances. Further, the SEC is asking whether the definition of a business in Regulation S-X, Article 11, should be aligned with that in accounting standards such as ASC 805.⁶

Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons

To ensure that investors receive relevant financial information about a registrant’s significant activities, Regulation S-X requires registrants that have a significant equity method investee to provide financial information about the investee in their filings with the SEC. The amount of information a registrant must present depends on the investee’s significance, which is determined by performing the applicable

³ The form, content, and requirements for pro forma financial information are outlined in Regulation S-X, Article 11, “Pro Forma Financial Information.”

⁴ The measurement of a business acquisition’s significance is subject to a series of tests, which are defined in Regulation S-X, Rule 1-02(w), “Significant Subsidiary.”

⁵ Regulation S-X, Rule 3-05(b)(2), “Periods to Be Presented,” requires that one, two, or three years of audited preacquisition financial statements be filed if significance exceeds 20 percent, 40 percent, or 50 percent, respectively, under the income, investment, or asset test.

⁶ FASB Accounting Standards Codification Topic 805, *Business Combinations*.

significant-subsidary tests.⁷ Depending on the outcome of the significance tests, registrants may be required to provide (1) separate audited and unaudited annual financial statements for each individually significant equity method investee or (2) summarized financial information,⁸ on an aggregate basis, for all investees. Different requirements must be considered for a registrant's interim financial statements⁹ as well.

The SEC acknowledges that financial information provided about significant equity method investees has certain limitations, particularly when such information is prepared by using accounting standards, fiscal year-ends, or reporting currencies that differ from those employed by the registrant. The SEC has requested input on ways to improve the usefulness of this information, including whether summarized financial information could be expanded. In addition, the Commission is seeking feedback on the appropriateness of the significance tests, including whether registrants that are evaluating significance should be allowed to use greater judgment rather than the current bright-line thresholds.

Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered

Issuers of registered securities that are guaranteed and guarantors of registered securities must provide separate annual and interim financial statements for each subsidiary issuer or guarantor. However, registrants that meet certain conditions may provide either of the following alternative disclosures in lieu of full financial statements:

- Condensed consolidating financial information in a footnote.¹⁰
- Narrative disclosures about any subsidiary issuer(s) or guarantor(s) in a footnote.

The request for comment is seeking input, among other things, on the usefulness of condensed consolidating financial information and narrative disclosures and whether such disclosures can be improved. In addition, the SEC is requesting feedback on whether Rule 3-10's requirements influence the guarantor structure and whether the conditions that a registrant must meet to present the alternative disclosures should be modified.

Financial Statements of Affiliates Whose Securities Collateralize an Issue Registered or Being Registered

Registrants are required to include separate financial statements of affiliates whose securities constitute a "substantial portion of the collateral"¹¹ for any class of securities registered or being registered. These disclosures are intended to help investors evaluate the affiliate's ability to satisfy its commitment in the event of default. However, in practice, Rule 3-16 may infrequently apply because the provisions in collateral agreements may limit the amount of collateral provided. The SEC is requesting feedback on whether the rule's requirements influence the structuring of collateral arrangements and on how to improve the rule to facilitate the disclosure of useful information to investors.

⁷ Rule 3-09 requires that separate audited financial statements of an individual equity method investment be provided if the investment is more than 20 percent significant on the basis of either the investment test or the income test. Regulation S-X, Rule 4-08(g), "Summarized Financial Information of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons," requires that summarized financial information be provided if either an individual equity method investment or an aggregated group of investments is more than 10 percent significant on the basis of the investment test, income test, or asset test.

⁸ Regulation S-X, Rule 1-02(bb).

⁹ Regulation S-X, Rule 10-01(b)(1), requires that registrants provide summarized financial information in their quarterly reports for any individual equity method investment for which separate financial statements would be required for annual periods.

¹⁰ Condensed consolidating financial information is presented in columnar format and may include any of the following columns as applicable: (1) the parent, (2) subsidiary issuer(s) of the security, (3) subsidiary guarantor(s), (4) nonguarantor subsidiaries, and (5) consolidating adjustments. The basis of accounting used to present the financial information is the same as the registrant's, except that investments in subsidiaries are accounted for under the equity method rather than consolidated.

¹¹ Rule 3-16(b) states that "securities of a person shall be deemed to constitute a **substantial** portion of collateral if the aggregate principal amount, par value, or book value of the securities as carried by the registrant, or the market value of such securities, whichever is the greatest, equals 20 percent or more of the principal amount of the secured class of securities" (emphasis added).

Other Matters

The SEC has encouraged all interested parties to provide feedback on any matters related to the financial information of entities other than the registrant, including financial statements for significant real estate operations¹² and whether investors would benefit from having such disclosures in XBRL format. The SEC has also requested input on broader topics such as other rules and forms that should be considered for review, how technology could be used to facilitate disclosure of useful information, and alternative approaches to presenting disclosures to make it easier to use that information. In addition, with respect to financial information of entities other than the registrant, the SEC is seeking input on whether disclosure requirements for smaller reporting companies, emerging growth companies, foreign private issuers, and investment companies should also be enhanced or modified.

¹² Under Regulation S-X, Rule 3-14, "Special Instructions for Real Estate Operations to Be Acquired."

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