

**Topic: Updating Requirements Relating to Financial Statements Prepared Pursuant to Rule 3-16 of Regulation S-X; Applicability of Rules 3-05, 3-09 and 3-14 and Article 11 and 12 of Regulation S-X to Rule 3-16 Financial Statements; Performing the Substantial Collateral Test Under Rule 3-16; Applicability of Rule 3-16 Following the Deregistration of the Underlying Collateralized Securities or the Termination of the Associated Collateral Arrangement; Interpreting the term “Class of Securities” for Purposes of Applying Rule 3-16**

**NOTICE:** The AICPA SEC Regulations Committee addresses with the SEC Staff emerging technical accounting and reporting issues relating to SEC rules and regulations in between regularly scheduled joint meetings. The purpose of the following discussion documents is to summarize the issues addressed with the SEC Staff. These discussion documents have not been considered and acted on by senior technical committees of the AICPA, or by the Financial Accounting Standards Board, and do not represent an official position of either organization.

In addition, these discussion documents are not authoritative positions or interpretations issued by the SEC or its Staff. The discussion documents were not transcribed by the SEC and have not been considered or acted upon by the SEC or its Staff. Accordingly, these discussion documents do not constitute an official statement of the views of the Commission or of the Staff of the Commission.

Background: There is relatively little published interpretive guidance relating to Rule 3-16 of Regulation S-X. The issues presented below are commonly encountered in practice. The Committee believes that public dissemination of the staff’s views on these issues would be beneficial to ensuring that investors are receiving the information that they need and that registrants can understand the reporting implications of collateral arrangements.

Updating requirements

Background: Company X is a calendar year-end SEC registrant whose stock is listed for trading on the New York Stock Exchange. In March 2005, Company X issued \$100 million senior secured notes in a private offering that was exempt from registration under the Securities Act. Company X’s senior secured notes are collateralized by the common stock of two of Company X’s wholly-owned subsidiaries (Subsidiary A and Subsidiary B). The common stock of Subsidiary A is deemed to constitute a “substantial portion” of collateral for Company X’s senior secured notes under Rule 3-16(b). The common stock of Subsidiary B does not constitute a “substantial portion” of collateral for Company X’s senior secured notes.

On June 14, 2005, Company X intends to file a registration statement on Form S-4 in order to register the offering of "exchange notes" for the outstanding "private notes." The exchange notes are substantially identical to the private notes, except that the exchange notes have been registered under the federal securities laws and will not bear any legend restricting their transfer.

Question 1: What financial statements of Subsidiary A must Company X include in the Form S-4?

View A: Rule 3-16 states that “...there shall be filed the financial statements that would be required if the affiliate were a registrant and required to file financial statements.” If Subsidiary A were a registrant and required to file financial statements it would need to include audited financial statements as of December 31, 2004 and 2003 and for each of the years in the three year period ended December 31, 2004 as well as unaudited financial statements as of March 31,

2005 and for the three month periods ended March 31, 2005 and 2004. Therefore, those are the financial statements that Company X must provide for Subsidiary A in the June 2005 Form S-4.

View B: Because 3-16 financial statements are not required in Form 10-Q/QSB, Company X only needs to include audited financial statements of Subsidiary A as of December 31, 2004 and 2003 and for each of the years in the three year period ended December 31, 2004. Unaudited financial statements would not be required. However, disclosures of any material changes or subsequent events from the date of the audited financial statements to the Form S-4 registration statement filing date should be provided.

Committee Recommendation: The Committee understands that the staff has historically held View A and that this same view has been applied by the staff without regard to whether the financial statements are included or incorporated by reference from a previously filed Exchange Act report (e.g., if 3-16 financial statements for Subsidiary A were previously filed in Company X's 2004 Form 10-K). The Committee believes that View B is more consistent with the notion of integration and that the financial statements of Subsidiary A required to be included in the Form S-4 should be no more than those that will be required on an ongoing basis in Company X's Exchange Act filings.

**SEC Staff Position: The Staff takes View A. The financial statements required by Rule 3-16 are those that would be required if Subsidiary A were a registrant and required to file financial statements. Rule 3-12 of Regulation S-X governs the age of financial statements in filings with the Commission. The Staff also reminds registrants that this conclusion is not limited to Form S-4 but would apply to any 1933 Act registration statement.**

Additional Background: Company X's registration statement on Form S-4 was declared effective on July 14, 2005 and included all financial statements that were required. Company X's annual report on Form 10-K for the year ended December 31, 2005 included audited financial statements of Subsidiary A as of December 31, 2005 and 2004 and for each of the years in the three year period ended December 31, 2005 pursuant to Rule 3-16.

On September 15, 2006, Company X filed a registration statement on Form S-3 to register the offer and sale of subordinated, unsecured notes in an underwritten offering. The securities of Subsidiary A will not serve as collateral for the subordinated unsecured notes. As required by the rules of the form, Company X incorporated its 2005 Form 10-K (including Subsidiary A's financial statements) into the Form S-3 .

Question 2: Is Company X required to provide any interim financial statements for Subsidiary A in the Form S-3?

View A: No. Because the Form S-3 is not registering securities for which the securities of Subsidiary A constitute a substantial portion of the collateral, Rule 3-16 is not applicable and therefore Company X does not need to provide updated financial statements for Subsidiary A.

View B: Yes. Company X is required to comply with Rule 3-16 in any registration statement or proxy/information statement that requires financial statements prepared in accordance with Regulation S-X. This is true without regard to the purpose of the registration statement/proxy/information statement. Since Company X has outstanding registered securities for which Subsidiary A's securities constitute a substantial portion of the collateral, any registration statement, or proxy/information statement that calls for financial statements required by Regulation S-X would need to include financial statements for Subsidiary A (including updated interim financial statements for periods required by Regulation S-X). Supporters of this view believe that investors in the subordinated, unsecured notes would benefit from having the detailed understanding the collateral position of Company X's senior secured noteholders which would be provided by the Rule 3-16 financial statements.

Committee Recommendation: The Committee supports View A. We understand that the staff has previously considered this question and has concluded consistent with View A. Based on this, the Committee also does not believe that updating would have been required if the offering were for common stock, or if Company X were filing a proxy/information statement that required financial statements prepared in accordance with Regulation S-X. If the new registration statement were on a form which did not require incorporation by reference of the most recent Form 10-K (e.g., Form S-1), then Company X would not need to include Subsidiary A's annual financial statements.

**SEC Staff Position: The Staff takes View A. The Staff also notes that this conclusion is not limited to Form S-3 (e.g., this would also be true if Company X were preparing a proxy statement).**

Other financial statement-related requirements

Question 3: Is Subsidiary A also required to comply with other financial statement-related requirements of Regulation S-X under Rules 3-09, 3-05, and 3-14 and Articles 11 and 12?

View A: Yes. Rule 3-16 states that “there shall be filed the financial statements that would be required if the affiliate were a registrant and required to file financial statements.” If Subsidiary A were a registrant, it would be required to provide financial statements (and financial statement-related information) that are specified by Rules 3-05, 3-09 and 3-14 and Articles 11 and 12. However, when analyzing which of these other rules is applicable to an affiliate, the registrant should consider the context of the underlying form. For instance, Rule 3-05 and Article 11 would not need to be considered in the complying with Rule 3-16 in Company X's Form 10-K because those parts of Regulation S-X do not apply to Form 10-K.

View B: No, unless the omission of the financial statements under Rules 3-05, 3-09 and 3-14 would render the registrant's financial statements substantially incomplete or misleading (a determination to be based on facts and circumstances). The reference in Rule 3-16 to “the financial statements that would be required if the affiliate were a registrant and required to file financial statements” was only intended to refer to the primary financial statements of the affiliate. It was not intended to cause the affiliate to comply with all elements of Regulation S-X.

Committee Recommendation: The Committee understands that in at least one fact pattern the staff has supported View A at least insofar as it related to Rule 3-09. The Committee believes that registrants should not be required to apply the requirements of Rules 3-05, 3-09 and 3-14 or the provisions of Articles 11 and 12 unless the omission of this information would render the registrant's (as compared to the affiliate's) financial statements substantially incomplete or misleading.

**SEC Staff Position: The Staff takes View A. Rule 3-16 is intended to provide investors with the financial statements that would be required by Regulation S-X (including Rules 3-05, 3-09, 3-14, Article 11 and Article 12) if Subsidiary A were a registrant and required to file financial statements. Rule 3-16 is not limited to the primary financial statements of the affiliate. However, as noted in View A, when analyzing which S-X rules are applicable to an affiliate, the registrant should consider the context of the underlying form (e.g., Article 11 and Rule 3-05 would not be applicable in a Form 10-K). Any significance test would be performed with respect to the affiliate, not the registrant. Registrants should contact the Staff of the Division of Corporation Finance (Office of the Chief Accountant) if they believe application of this view to their specific facts and circumstances results in an illogical answer or if the registrant believes the information not meaningful to an understanding of the collateral.**

**Although not specifically addressed in Question 3, the Staff also takes View A with respect to subsidiary guarantors/issuers that are not relieved of their separate reporting obligations by the operation of Rule 3-10(b)-(f). Subsidiary guarantors/issuers that are not relieved of their separate Exchange Act reporting obligations (e.g., under Rule 12h-5) would also need to comply with their ongoing reporting responsibilities (e.g., filing Form 8-Ks).**

*Performing the substantial collateral test*

Question 4: As of what date should the tests be performed to determine whether Subsidiary A's and Subsidiary B's securities constitute a substantial portion of the collateral for the senior secured notes in connection with the June/July 2005 Form S-4?

View A: The tests should be performed using information as of the end of the most recently completed fiscal year for which audited 3-16 financial statements would be required in the particular filing. The numerator should be based on the affiliate information as of December 31, 2004 in this case.

View B: The numerator used in the "substantial collateral" test should be determined using information as of the end of the most recently completed fiscal period (annual or interim) for which financial statements would be required in the registration statement. The numerator should be based on the affiliate information as of March 31, 2005 in this case.

View C: The numerator used in the "substantial collateral" test should be determined using information as of the date of filing the registration statement and again as of the effective date of the registration statement. The numerator should be based on the affiliate information as of June 14, 2005 and as of July 14, 2005 in this case.

View D: The test should be performed as of the end of the most recently completed fiscal year for which audited 3-16 financial statements would be required in the particular filing and as of the end of the most recently completed interim period for which financial statements would be required in the registration statement. The numerator should be based on the affiliate information as of December 31, 2004 and as of March 31, 2005 in this case.

Committee Recommendation: The Committee supports View A. Similar to significance testing under Rule 1-02(w), the numerator of the "substantial collateral" test should be performed based on the most recently completed year for which financial statements would be required by Rule 3-16.

**SEC Staff Position: The Staff takes View A. This is consistent with the manner in which significance testing is performed under Rule 1-02(w) of Regulation S-X.**

Question 5: Must Company X re-perform the substantial collateral test as of December 31, 2005 to determine whether Subsidiary A's and Subsidiary B's audited financial statements need to be included in Company X's 2005 Form 10-K?

View A: Yes. Assuming that the notes are still registered and the collateral arrangements are still in place, Company X must re-perform the substantial collateral test as of the end of each fiscal year for each of its affiliates whose securities collateralize registered debt to determine if the securities constitute a substantial portion of the collateral as of the end of the year. This means that Company X might need to include audited financial statements in its Form 10-K for affiliates whose financial statements were not required in the initial registration statement (because their securities did not meet the definition of "a substantial portion of the collateral" at that time).

View B: No. The substantial collateral test only needs to be performed at the time the registration statement for the collateralized securities is first declared effective.

Committee Recommendation: The Committee supports View A.

**SEC Staff Position: The Staff takes View A. Where applicable, the substantial collateral test must be performed in connection with each subsequent Form 10-K filing. The financial statements to be included would be those that would be required if the affiliate were a registrant and required to file financial statements with the Commission (e.g., 2 year-end balance sheets and statements of income, cash flows and changes in stockholder's equity, and Article 12 schedules for 3 years--all audited).**

**If an affiliate whose securities previously did not constitute a significant portion of collateral becomes significant as of the end of the current fiscal year, then financial statements for that affiliate must be provided for all periods as if that affiliate were a registrant (not just for the period in which the affiliate met the significance test). The Staff notes that if financial statements are required, they must be audited for all annual periods. Refer also to Question 14.**

Additional Background: In November 2006, Company X extinguishes \$50 million par value of the senior secured notes.

Question 6: Must Company X re-perform the substantial collateral test as of December 31, 2006 based on the amount of principal outstanding as of that date?

View A: Yes. Consistent with View A in Question 5 above, the test must be performed annually. Whenever the test is being performed, it should be performed based on the principal amount of the class of registered collateralized securities for which the test is being performed. All else being equal, as the outstanding amount of principal decreases, the portion of the collateral represented by a given affiliate's securities increases. Therefore the relevance to the remaining security holders increases.

View B: No. The denominator of the substantial collateral calculation should always be the amount of principal which was initially outstanding.

Committee Recommendation: The Committee supports View A. The Committee would recommend that registrants for which this answer yields an illogical result (e.g., if a very small amount of debt remains outstanding) should contact the staff of the Division of Corporation Finance.

**SEC Staff Position: The Staff takes View A. Registrants should consult with the Division of Corporation Finance Staff (Office of the Chief Accountant) if they believe that the calculation yields an illogical result.**

Question 7: How should the "market value" test be performed for an affiliate whose securities that serve as collateral for a class of registered securities are not traded on an exchange or in an over-the-counter market?

View A: The term "market value" should be read "fair value". The registrant must make a reasonable estimate of the amount that a willing buyer and a willing seller would exchange. From an investor's perspective the fact that the affiliate's securities are not traded on an exchange or in an over-the-counter market does not change the fact that the affiliate may constitute a substantial portion of the collateral because of its significant market value.

View B: Due to the fact that the affiliate's securities are not traded on an exchange or in an over-the-counter market, the market value of the securities for purposes of Rule 3-16 is \$0. Therefore, the numerator in the "substantial collateral" test would be the greatest of the aggregate principal amount, par value or book value of the securities as carried by the registrant.

Committee Recommendation: The Committee supports View A. Registrants should also refer to the guidance included in the AICPA Audit and Accounting Practice Aid Series, *Valuation of Privately-Held-Company Equity Securities Issued as Compensation*.

**SEC Staff Position: The Staff takes View A.**

*Deregistration of collateralized debt*

Question 8: If Company X were to file a Form 15 with respect to the collateralized notes before December 31, 2006, would Company X be required to perform the substantial collateral test as of December 31, 2006?

Note: For purposes of Questions 8, 9 and 10, assume that Company X's reporting obligation under section 13(a) of the Exchange Act is not terminated (i.e., their common stock remains listed on the New York Stock Exchange).

View A: No. If Company X's reporting obligation with respect to the collateralized notes is suspended, it would not be required to provide financial statements under Rule 3-16. Once the reporting obligation with respect to the collateralized notes has been suspended (whether following the filing of a Form 15 or statutorily pursuant to Section 15(d) of the Exchange Act), Rule 3-16 would no longer apply to that specific class of securities. Supporters of View A believe that a 3-16 entity is not a registrant and does not have an Exchange Act reporting obligation separate and apart from its parent.

View B: Yes. As long as Company X retains a '34 Act reporting obligation, it must continue to perform the substantial collateral test at the end of each year until the collateralized notes are extinguished.

Committee Recommendation: The Committee supports View A.

**SEC Staff Position: The Staff takes View A.**

Question 9: Would the answer in Question 8 be different if Subsidiary A and Subsidiary B were also guarantors of the collateralized debt and they availed themselves of the relief from Exchange Act reporting provided by Rule 12h-5?

View A: No. If the reporting obligation relating to the collateralized notes has been suspended, Rule 3-16 no longer applies to that class of securities. However, while full financial statements may no longer be required under Rule 3-16, the reporting requirements of Rule 3-10 must be evaluated separately.

View B: Yes. Since Company X's reporting Exchange Act reporting obligations have not been terminated (i.e., it is still registered under Section 12 of the Exchange Act) and since Subsidiary A and Subsidiary B availed themselves of the reporting relief provided by Rule 12h-5, Company X must follow the "for as long as the debt is outstanding" concept articulated in Rule 3-10 with respect to the requirements of Rule 3-16.

Committee Recommendation: The Committee supports View A.

**SEC Staff Position: The Staff takes View A.**

Question 10: If the deregistration of Company X's collateralized notes were to become effective January 1, 2007, would Company X need to perform the substantial collateral test as of December 31, 2006?

View A: No. Since the reporting obligation relating to the collateralized notes was suspended prior to the filing of the 2006 Form 10-K, Company X need not include financial statements under Rule 3-16 in that Form 10-K. Supporters of View A note that if a class of securities is still outstanding at the 10-K due date but the registrant goes private (e.g., in a transaction under Rule 13e-3) and files a Form 15 before the original 10-K due date, then no 10-K filing is required. However, if the Form 10-K related to the year in which the registration statement for the collateralized debt was declared effective (December 31, 2004 in this example), then the fact that the reporting obligation is suspended prior to the due date of that Form 10-K (e.g., automatically by operation of section 15(d) of the Exchange Act) would not eliminate the need to comply with Rule 3-16 in that Form 10-K. In other words the Form 10-K for the year in which the registration statement was declared effective would need to comply with Rule 3-16 even if the reporting obligation relating to the collateralized debt was suspended before the due date of that Form 10-K (e.g., at the beginning of the subsequent fiscal year).

View B: Yes. Company X's collateralized notes were still registered as of December 31, 2006, accordingly, Company X should perform the substantial collateral test as of December 31, 2006 and should provide any required financial statements in its 2006 Form 10-K. Supporters of View B believe that because Company X retained a section 13(a) reporting obligation that it must perform the "substantial collateral" test as of December 31, 2006.

Committee Recommendation: The Committee supports View A.

**SEC Staff Position: The Staff takes View A.**

#### Termination of collateral arrangement

Question 11: If Company X were to terminate the collateral agreement prior to December 31, 2006 (either automatically by operation of the underlying indenture or by securing the consent of the noteholders), would Company X be required to perform the substantial collateral test in connection with preparing its 2006 Form 10-K?

View A: No. Since the collateral agreement was terminated prior to December 31, 2006, Company X is not required to perform the substantial collateral test as of December 31, 2006.

View B: Yes. Company X should not stop performing the substantial collateral test until 2007.

Committee Recommendation: The Committee supports View A.

**SEC Staff Position: The Staff takes View A.**

Question 12: If Company X were to terminate the collateral agreement (either automatically by operation of the underlying indenture or by securing the consent of the noteholders) after December 31, 2006 but before the 2006 Form 10-K is filed, would Company X be required to perform the substantial collateral test in connection with preparing its 2006 Form 10-K?

View A: No. Since the collateral agreement was terminated prior to the filing date of the 2006 Form 10-K, Company X is not required to perform the substantial collateral test as of December 31, 2006. Since the collateral arrangements were terminated prior to filing the 2006 Form 10-K, Company X should not be required to incur the expense associated with reporting to support a collateral arrangement that no longer exists.

View B: Yes. Company X should not stop performing the substantial collateral test until 2007.

Committee Recommendation: The Committee supports View A. This is consistent with the conclusion in Question 10.

**SEC Staff Position: The Staff generally takes View A and notes that the inclusion of Rule 3-16 financial statements could be confusing to investors because the affiliate's securities no longer serve as collateral. However, there may be situations involving adverse credit events that may warrant presentation of 3-16 financial statements for the most recent fiscal year, with full disclosure of the circumstances and status of the collateral.**

**The Staff notes that this answer would be different for changes in guarantee structures under Rule 3-10. Disclosure under Rule 3-10 would follow the guarantee structure in place as of the fiscal year end and not reflect any subsequent modifications.**

*Interpreting the phrase "class of securities"*

Background: Company Y intends to issue 2 new series of notes in a transaction to be registered under the Securities Act. Each series of notes will be collateralized by the stock of Company Y's 2 wholly-owned subsidiaries Subsidiary D and Subsidiary E. Each series of notes will have identical terms except for repayment terms and interest rate. Both series of notes will be issued under the same indenture.

Question 13: In Company Y's situation, how should the phrase "class of securities" be interpreted for purposes of performing the substantial collateral test?

View A: Company Y should perform the substantial collateral test individually for each of the 2 series of collateralized notes.

View B: Because the two series of notes were issued under the same indenture, Company Y may add the principal amount of the two series of notes together for purposes of performing the substantial collateral test.

Committee Recommendation: The Committee supports View A. The Committee believes that the phrase "class of securities" is intended to mean that all terms of the securities (including interest rate, repayment terms, maturity date, and collateral arrangements) are identical and the securities were issued under the same indenture.

**SEC Staff Position: The Staff generally takes View A. If registrants have questions about the interpretation of the phrase "class of securities," they should consult with the Staff of the Division of Corporation Finance (Office of the Chief Counsel).**

*Previously provided 3-16 financial statements*

Question 14: If the securities of an affiliate for which financial statements were previously provided pursuant to Rule 3-16 do not represent a substantial portion of collateral as of the succeeding year, must the financial statements of the affiliate be provided in that subsequent year's Form 10-K?

View A: No. If the affiliate's securities do not constitute a substantial portion of the collateral as of the end of the most recently year, then no financial statements for that affiliate for any year are required under Rule 3-16.

View B: Yes. Since if the affiliate's securities constituted a substantial portion of the collateral for any of the years to be presented by Regulation S-X, then similar to Rule 3-09, the financial statements of the affiliate must be presented for all periods.

Committee Recommendation. The Committee supports View A.

**SEC Staff Position: The Staff takes View A. The requirement to comply with Rule 3-16 is based only on the most recently completed fiscal year. This is different from Rule 3-09 which applies to each year and which expressly permits the filing of unaudited financial statements for periods in which the equity method investee or unconsolidated subsidiary was not significant, if audited financial statements of the investee are required for other periods in which it was significant. Refer to Question 5.**