

Discussion Document A – June 20, 2006

Topic: Whether Parent Company Financial Information Is Required When the Registrant has a Consolidated Shareholders' Deficit

Background: Company X is a calendar year-end SEC registrant. Company X has two wholly-owned subsidiaries: Subsidiary A and Subsidiary B. Due to restrictive bank covenants, Subsidiary A and Subsidiary B are both prohibited from transferring any funds to their parent (by dividend, loan, return of capital or otherwise). On a consolidated basis, Company X has a shareholders' deficit comprised of the following (assuming full pushdown of all consolidating entries):

	<u>Example 1</u>	<u>Example 2</u>	<u>Example 3</u>
Net Assets of Subsidiary A	\$25	\$25	\$25
Net Liabilities of Subsidiary B	(35)	(50)	(150)
Parent Company-Only			
Net Assets (Liabilities)	<u>(10)</u>	<u>5</u>	<u>105</u>
Consolidated shareholders' deficit	<u>(\$20)</u>	<u>(\$20)</u>	<u>(\$20)</u>

SAB Topic 6-K, which provides an interpretation of ASR No. 302 – Separate Financial Statements Required by Regulation S-X, states that parent company disclosures about the nature and amount of significant restrictions on the ability of subsidiaries to transfer funds to the parent through intercompany loans, advances or cash dividends, and the presentation of condensed parent company financial information and other data in a schedule (Rule 12-04) are required in certain circumstances. SAB Topic 6-K provides guidance in determining which disclosures, if any, are required. It states that a registrant must compute its proportionate share of the net assets of its consolidated and unconsolidated subsidiary companies as of the end of the most recent fiscal year which are restricted as to transfer to the parent company because the consent of a third party (a lender, regulatory agency, foreign government, etc.) is required. If the registrant's proportionate share of the restricted net assets of consolidated subsidiaries exceeds 25% of the registrant's consolidated net assets, both the footnote and schedule information are required. If the amount of such restrictions is less than 25%, but the sum of these restrictions plus the amount of the registrant's proportionate share of restricted net assets of unconsolidated subsidiaries plus the registrant's equity in the undistributed earnings of 50% or less owned persons (investees) accounted for by the equity method exceed 25% of consolidated net assets, the footnote disclosure is required.

SAB Topic 6-K indicates in Question 3 that a subsidiary with excess of liabilities over assets would not be considered to have any restricted assets for purposes of the test. However, SAB Topic 6-K does not provide guidance on conducting the test when the registrant has a consolidated shareholders' deficit. The guidance in the SAB states that "The objective of the tests is to require parent company disclosures when the parent company does not have control of its subsidiaries' funds because it does not have unrestricted access to their net assets. The tests trigger parent company disclosures only

when there are significant third party restrictions on transfers by subsidiaries of net assets and the subsidiaries' net assets comprise a significant portion of consolidated net assets.”

Question: Is Company X required to provide any parent company financial information in its annual report on Form 10-K?

View A: Yes. Company X should exclude Subsidiary B from the calculation of restricted net assets (because Subsidiary B has net liabilities). However, Company X must compare the restricted net assets of Subsidiary A to the absolute value of the consolidated shareholders' deficit (i.e., \$20). Since this amount exceeds 25% Company X must provide parent company financial information.

View B: No. Since Company X has a consolidated shareholders' deficit it does not have any net assets to be considered “restricted.” This is consistent with the guidance in SAB Topic 6-K which states that a subsidiary with net liabilities has no restricted net assets and therefore should be counted as \$0 in calculating the amount of restricted net assets.

View C: Yes. Since Company X has a consolidated shareholders' deficit its net asset base for purposes of calculating the proportionate share of restricted net assets of consolidated subsidiaries should be \$0. Therefore, any restrictions placed on the net assets of subsidiaries with positive equity would result in the 25% threshold being met and a corresponding requirement to provide parent company financial information. This is consistent with the guidance in SAB Topic 6-K which states that a subsidiary with an excess of liabilities over assets has no restricted assets. Therefore, a parent with an excess of liabilities over assets should be considered to have no net assets.

View D: The answer would depend on the facts and circumstances as illustrated below. For purposes of the 25% calculation:

- The denominator (consolidated net assets) should be adjusted to exclude any subsidiary with a deficit (i.e., add back the deficit of any subsidiary with a net deficit) whether or not that subsidiary is subject to transfer restrictions,
- The 25% calculation should then be performed using the adjusted denominator if positive,
- If after such adjustment, a consolidated deficit remains (i.e., because the parent deficit is greater than the total net assets of subsidiaries with positive net assets), the absolute value should not be used as a denominator. Instead, in those cases, parent company financial information should always be provided (when net asset restrictions otherwise exist at any subsidiary that has positive net assets) because it would be material to holders of the parent's securities to understand that it has a deficit. That is, apply View C if the adjustment still results in deficit.

The following illustrates the application of View D to the three example scenarios:

Example	1	2	3
Consolidated Deficit	(\$20)	(\$20)	(\$20)
Add back: All subsidiaries with deficits	35	50	150
Denominator: Parent and subsidiaries with net assets	\$15	\$30	\$130
Numerator: Restricted net assets of subsidiaries	\$25	\$25	\$25
Percentage restriction	>100%	83%	19%
Parent company information	Yes	Yes	No

Committee Recommendation: The Committee believes that View C is most consistent with existing guidance. However, the Committee believes that View D is a more reasonable and appropriate approach.

SEC Staff Position: The staff takes View C but also indicated that registrants should consult with the staff if they have a specific fact pattern which would lead to an answer that would provide more meaningful disclosure to investors.