

## **Discussion Document C**

**Topic: Application of Regulation S-X Rule 3-05 “Financial Statements of Businesses Acquired or to be Acquired” and Rule 3-09 “Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons” when the registrant is a successor to a predecessor company.**

### **Background:**

Rule 3-05 requires a registrant to file the financial statements of a business acquired if the business acquired is significant at over the 20% level under the income test (or asset or investment tests), in Rule 1-02(w). Rule 3-09 requires a registrant to file the financial statements of an equity method investee if the investee is significant at the 20% level under the income test (or investment test) in Rule 1-02(w).

### **Question:**

It is not clear how a registrant should apply the income test of Rule 3-05 and Rule 3-09 when the registrant is a successor to a predecessor company, such as in the case when a registrant emerges from bankruptcy and adopts fresh-start reporting during the year or push down accounting is used to reflect a change in basis, and as such the registrant does not have a full year of income statement information to serve as the basis in the calculation of the income test under Rule 1-02(w).

In seeking to interpret Rule 3-05 and Rule 3-09, although not authoritative, the interpretive guidance in C.C.H.’s Accounting Research Manager relating to the significant subsidiary test in predecessor/successor situations states:

When the registrant is the successor to a predecessor company (for which audited financial statements are also included) and the registrant subsequently acquires a business, the significant subsidiary test should be performed using only the results of operations of the successor company (i.e., the registrant) in the denominator. Alternatively, if precleared with the SEC staff, the staff may allow the significant tests to be performed using pro forma amounts for the registrant, computed as if the predecessor company had been purchased as of the beginning of the fiscal year being measured. The pro forma financial statements used for the computation would need to be prepared in accordance with Article 11.

In addition, a Big 4 accounting firm’s guidance relating to successor/predecessor financial statements states:

When a registrant’s most recent fiscal year includes successor- and predecessor-basis financial statements, the registrant may determine the income base using the historical pre-acquisition and post-acquisition combined income (or loss) of the registrant and its predecessor. In some circumstances, the SEC staff has not objected to the use of pro forma successor-basis income from continuing

operations (assuming for example, that the change in basis had occurred at the beginning of the fiscal year). Registrants may seek SEC staff permission to use pro forma calculations by written request to the Chief Accountant of the Division of Corporation Finance.

View A:

The registrant should use the successor registrant period to serve as the basis for the application of the significant subsidiary income test in Rule 1-02(w).

View B:

The registrant may use the combined results of operations of the predecessor and successor for a full year to serve as the basis for the application of the significant subsidiary income test in Rule 1-02(w).

View C:

The registrant may use the pro forma results of operations of the successor computed as if the transactions that resulted in the predecessor and successor periods (i.e. emergence from bankruptcy and adoption of fresh-start reporting) for the registrant had occurred as of the beginning of the year to serve as the basis for the application of the significant subsidiary income test in Rule 1-02(w).

**Committee Recommendation:**

The committee recommends View B but also notes that View C would be acceptable provided it is pre-cleared with the staff.

**SEC Staff Response: The staff agrees with View A and indicated that View C may be acceptable on a facts and circumstances basis, provided it is pre-cleared with the staff. Related to View B, the staff noted that in most cases, combining the results of the successor and predecessor does not yield a meaningful result. If a registrant believes View B is appropriate, it should be pre-cleared with the staff.**

