

## **Discussion Document B**

### **Topic: Rule 3-09 Financial Statements in the Year in which an Investee is Disposed (Revisit of discussions from various prior meetings) (Revised Discussion Document B from June '06 Meeting)**

**Background:** Rule 3-09 of Regulation S-X requires financial statements of a significant equity method investee. In prior meetings, we have discussed the issue of whether Rule 3-09 applies in the year an equity method is disposed (March 2001). We have also discussed whether the income test in the year of disposition should include the gain/loss from the disposition of an equity method investee and whether the income test should include the gain/loss from a partial disposition if the partial disposal causes the remaining investment in a formerly consolidated investee to be accounted for using the equity method (June 2005). The staff's views have been that Rule 3-09 does apply in the year of disposition, and any gain/loss on disposal must be included in the numerator for the income test. Excerpts from relevant (but not all) prior discussions of these issues are shown for reference purposes below. (They have been edited to remove discussion of other matters.)

**Discussion:** The Committee believes that Rule 3-09(a), which is written in the present tense, could be read to apply only to an equity method investment that is owned by the registrant at the end of the year in question. The Committee believes that this would be a logical reading of the Rule, because it believes that audited investee financial statements are not relevant to investors once the registrant has disposed of its investment. We acknowledge that the amount of any gains or losses on disposition may be of relevance to investors in evaluating management's track record. But we question a reading of Rule 3-09 which seemingly concludes that an investor needs more information regarding a disposed equity method investment than he or she needs regarding a consolidated investment. Rather, we believe that sufficient information is already required by APB 18, Rule 4-08(g), and the MD&A rules. Based on our experiences in working with registrants that have encountered this issue, our sense is that registrants share this view.

**Question:** We ask the SEC Staff to reconsider its previous interpretations regarding the need for Rule 3-09 financial statements and calculating significance of investees in these fact patterns. If the staff concludes these are the only appropriate interpretations of the Rule, then we ask the staff to consider asking the Commission to modify the Rule. Any such modification could address these issues, clarify the time at which investee financial statements must be filed when the registrant and investee have different year-ends (this has been a source of practice questions; see, for example, the minutes of our June 2001 meeting), and address the need for technical corrections discussed with the staff in our April 2006 meeting.

## Excerpts From Prior Discussions:

The minutes of the March 2001 Committee meeting state:

Question: When a registrant disposes of a significant equity method investee during the latest fiscal year, what Rule 3-09 investee financial statements does it need to present in its Form 10-K?

Background: When a registrant's equity method investee is 20% significant under the investment test or the income test of Rule 1-02(w) of Reg. S-X, Rule 3-09 requires the registrant to include audited financial statements of the investee in its Form 10-K. The Staff Training Manual (III.A of Topic 2) states that "the financial statements required should be for the *same annual audited periods as required by Rule 3-01 and 3-02.*" *It also indicates that "financial statements are not required for periods prior to the registrant's ownership of the investment."* (emphasis added)

Discussion: Year of disposition - Rule 3-09 and the guidance above raise the question of whether Rule 3-09 investee financial statements should continue to be provided after a registrant has disposed of its investment in the investee. The investee's financial statements could be necessary because either (a) current year income from the investee is significant to the registrant or (b) the investee was significant in prior years. The potential need to provide these financial statements raises both practical and relevance issues.

By disposing of its investment, the registrant moves from a position of significant influence to one of no influence. Therefore, the registrant may be unable to require the former investee to provide audited or unaudited financial statements. This problem becomes even more difficult if the investee's financial statements should cover only the period through the disposition date.

It is also unclear whether investors need investee financial statements when the registrant no longer owns the investment. Presenting summarized financial information for the investee pursuant to Rule 4-08(g) might be sufficient. This approach would be similar to the approach an investor uses after it disposes of a consolidated investee that is reported as a discontinued operation under APB 30. (Paragraphs 8 and 18 of APB 30 require information which is similar to the information called for by Rule 4-08(g).<sup>1</sup>) It seems inappropriate to require more information for an equity method investee that has been sold than is required for a consolidated investee that has been sold. Will the staff permit presentation of summarized information (Rule 4-08(g)) in lieu of full audited financial statements of the investee in the year of disposition? If not, will the staff permit financial statements

---

<sup>1</sup> These paragraphs of APB 30 have been superseded by FASB Statement 144. Statement 144 contains similar disclosure requirements.

of the investee for the entire year in lieu of financial statements through the date of disposition?

Staff Comment: The staff will favorably consider the kind of relief described in this question if the registrant determines that the financial statements specified by the rule cannot be obtained without undue difficulty or cost. However, if the investee is sold near the end of the most recent year, the staff may be more reluctant to waive the requirement if the investee is very significant quantitatively or qualitatively during that year. In this circumstance, the staff will consider, among other things, the significance of the registrant's participation in the investee's business, whether similar investments comprise a significant part of the registrant's business, and whether significant intercompany transactions have occurred.

The minutes of the July 2003 meeting of the International Practices Task Force state:

The SEC Staff noted that during the recent season of Form 20-F filings it had encountered a number of "last minute" issues with Rule 3-09 financial statements in which the registrant had realized at the last moment that Rule 3-09 financial statements were required and had asked for waivers. In some cases, there was a disagreement between the registrant and the investee as to the basis of accounting to be adopted by the investee and registrants also had asked for waivers of the Rule 3-09 requirements on that basis. Generally, the Staff will not waive financial statements under Rule 3-09, except where the investee was historically insignificant to the registrant, the investment was disposed of during the most recent year, and the gain on sale caused the significance test to be met for the first time. Neither operating or impairment losses of an investee, nor impairments of the registrant's investment would ordinarily be a basis for waiver, even if the registrant's investment was reduced to nil under U.S. GAAP. The SEC Staff encourages registrants to discuss the need to test the significance of investees as soon as possible in the timetable for preparing and filing the Form 20-F.

The minutes of the June 2005 Committee meeting state:

Question 1: How should a registrant apply the income test in Rule 1-02(w) in determining significance in the year a formerly consolidated wholly-owned or majority-owned subsidiary becomes an equity method investee?

Background: Under Rule 3-09, the significance of a registrant's equity investee is determined by reference to the significance tests in Rule 1-02(w). The income test requires the comparison of income from continuing operations before income taxes,

extraordinary items, and cumulative effect of a change in accounting principle of the equity method investee with such income of the registrant. Although not specified in Rule 1-02(w), the SEC staff also believes that the income test should include the gain/loss from the disposition of an equity method investee.

View A – The registrant should calculate the income test based on the registrant’s equity in the investee’s pretax earnings for the period of the fiscal year in which it was accounted for by the equity method. In addition, any gain or loss arising from the transaction that caused the former subsidiary to become an equity investee should not be included in the significance test.

View B – The registrant should calculate the income test based on the registrant’s equity in the investee’s pretax earnings for the full fiscal year. That is, the significance test would be based on the actual ownership interest for the respective periods of the fiscal year. In addition, any gain or loss related to changes in ownership of the subsidiary/investee would be included in the significance test.

View C– The registrant should calculate the income test based on the registrant’s equity ownership interest applied to the gross pretax earnings of the subsidiary/investee for the full fiscal year. View C essentially represents a pro forma computation as if the equity interest had been held since the beginning of the year. View C attempts to approximate the likely results of the income test in subsequent years. Any gain or loss arising from the transaction that caused the former subsidiary to become an equity investee should not be included in the significance test.

Committee Recommendation: The committee supports View A.

Staff Response: The Staff takes View A, with modification. The Staff stated that any gain or loss related to changes in ownership of the subsidiary/investee should be included in the significance test (the Committee’s view under View A was that any gain or loss should not be included). The Staff further commented that if the equity investee would be determined to be significant under View B, then the Staff would expect robust disclosure in the registrant’s Management Discussion and Analysis in its Form 10-K since such significance would indicate that the results of operations of the former wholly-owned subsidiary was material to the registrant and should be discussed.

**SEC Staff Position: There has been no change in the SEC staff position on this matter.**

