**SEC Regulations Committee**

**October 11, 2007 - Joint Meeting with SEC Staff**

**SEC Offices – Washington DC**

## Discussion Document C

**Topic: Application of Rule 3-05(b)(3) of Regulation S-X Regarding Financial Statements Used to Measure Significance When an Acquired or to be Acquired Business Is a Successor to a Predecessor Company**

**Issue:** What financial statements should a registrant use to measure significance of an acquiree when the acquiree's most recent pre-acquisition annual financial statements present predecessor and successor results?

**Background:** In some instances, an acquired or to be acquired business (acquiree) is a successor to a predecessor company, or an acquiree presents financial statements that include predecessor and successor results. Examples include adoption of fresh-start accounting after emergence from bankruptcy, use of push-down accounting to reflect a change in basis, or when a shell company acquires another company that is determined to be its predecessor. In these situations, the acquiree may not have a full year of income statement data reflecting the successor results. For example, if push-down accounting was applied, the periods prior to the change in basis represent the predecessor and the periods subsequent to the change in basis represent the successor.

S-X Rule 3-05(b)(3) states "The determination shall be made by comparing the most recent annual financial statements of each such business, or group of related businesses on a combined basis, to the registrant's most recent annual consolidated financial statements filed at or prior to the date of acquisition."

At the June 6, 2006 SEC Regulations Committee meeting (Discussion Document C), the committee discussed a similar situation when the *registrant* is a successor to a predecessor company (affecting the denominator of the significance calculation discussed above). The question was how the registrant should apply the income test in this situation. The SEC Staff indicated that the registrant should use the successor-only registrant period for purposes of this test, however the Staff also indicated that it might be appropriate to use 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). With respect to combining the predecessor and successor periods for a full year to serve as the basis, 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 this view is appropriate, it should be pre-cleared with the staff.

**Question 1:** What financial statements of the acquiree should be used in the numerator for comparison to the registrant's financial statements in situations where the acquiree is a successor to a predecessor company?

View A

Combine the predecessor and successor periods in the numerator for the purposes of performing the income test.

View B

Use the predecessor-only period in the numerator for the purpose of performing the income test.

View C

Use the successor-only period in the numerator for the purpose of performing the income test.

View D

Prepare pro forma financial information in accordance with Article 11 of Regulation S-X of the acquiree as if the successor company existed as of the beginning of the latest annual period and use this information in the numerator for the purpose of performing the income test. If this view results in a distorted or impracticable approach, the company should pre-clear their circumstances with the SEC Staff.

**Committee Recommendation:** The committee recommends View D.

**SEC Staff Position:**

**The staff noted that there is no single answer to this question. A registrant should start with a literal reading of the rule (as described in View C) and determine whether the result is conclusive as to significance (e.g., clearly over 50%) or whether the period of the successor's operations included is close enough to 12 months to be a reliable indicator of significance. If not, the registrant should consider which alternative measurement or measurements make the most sense based on the facts and circumstances. The staff also stated that the convention of "9 months equals 12 months" as contemplated in Rule 3-06 of Regulation S-X does not apply in this situation.**

**The staff noted that the application of Rule 3-05(b)(3) in this fact pattern requires the use of judgment to determine whether the objective of the rule is being achieved. Registrants with specific questions or uncertainties are encouraged to contact the staff.**

**Question 2**: What financial statements should a registrant use to measure significance of an acquiree when the acquiree's most recent pre-acquisition annual financial statements present **predecessor-only** results (i.e., the acquisition occurs in the fiscal year of succession)?

View A

Use the predecessor-only period in the numerator for the purpose of performing the income test.

View B

Prepare pro forma financial information in accordance with Article 11 of Regulation S-X of the acquiree as if the successor company existed as of the beginning of the latest annual period and use this information in the numerator for the purpose of performing the income test. If this view results in a distorted or impracticable approach, the company should pre-clear their circumstances with the SEC Staff.

**Committee Recommendation:** The committee recommends View B.

**SEC Staff Position: The staff supports View A for the reasons cited in Question 1.**