

**SEC Regulations Committee**  
**October 11, 2007 - Joint Meeting with SEC Staff**  
**SEC Offices – Washington DC**

**Discussion Document F**

**Topic:** Application of Rules 3-09 and 4-08(g) of Regulation S-X to Investments Accounted for Using the Fair Value Option under Statement of Financial Accounting Standards No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities.” that Otherwise Would be Accounted for Under the Equity Method under APB 18, “The Equity Method of Accounting for Investments in Common Stock.” (Discussion Document E from July 10, 2007 Joint Meeting)

**Issue:** Do S-X Rules 3-09 and 4-08(g) apply to an investment that is accounted for using the fair value option under Statement of Financial Accounting Standards No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities” (SFAS 159), which would otherwise have been accounted for by the equity method under APB 18, “The Equity Method of Accounting for Investments in Common Stock” (APB 18)? If so, how should a company perform the income test of significance under S-X Rule 1-02(w)?

**Background:** SFAS 159 permits a company to account for financial assets, including investments that are otherwise required to be accounted for under the equity method, using the fair value option. Under the fair value option, the investment is reflected on the balance sheet at fair value, with changes in fair value between reporting periods reflected in the income statement. The investor would no longer record its share of investee income or loss in the income statement.

For investments that would have been accounted for under the equity method if the entity had not chosen to apply the fair value option, paragraph 18.f of SFAS 159 carries forward many of the disclosure requirements of paragraph 20 of APB 18, including the requirement in paragraph 20.d:

When investments in common stock of corporate joint ventures or other investments accounted for under the equity method are, in the aggregate, material in relation to the financial position or results of operations of an investor, it may be necessary for summarized information as to assets, liabilities, and results of operations of the investees to be presented in the notes or in separate statements, either individually or in groups, as appropriate.

Rule 3-09 of Regulation S-X requires separate financial statements of a “50 percent or less owned person accounted for by the equity method either by the registrant or a subsidiary of the registrant” if either the investment test or the income test specified in Rule 1-02(w) of Regulation S-X are met at the 20% significance level.

Rule 4-08(g) of Regulation S-X requires summarized financial information, as specified in 1-02(bb) of Regulation S-X, in the notes to the financial statements for “50 percent or less owned persons accounted for by the equity method by the registrant or by a subsidiary of the registrant” if any of the tests specified in Rule 1-02(w) of Regulation S-X are met at the 10% significance level, either individually or in the aggregate.

For the income test of significance, Rule 1-02(w) of Regulation S-X specifies the numerator in the calculation to be the registrant's equity in the pre-tax income of the investee.

**Question 1:** Does Rule 3-09 of Regulation S-X apply to an investment that is accounted for using the fair value option under SFAS 159 that otherwise would be accounted for using the equity method under APB 18?

View A

No, S-X Rule 3-09 is not applicable to an investment accounted for using the FAS 159 fair value option. Unless the SEC makes a technical rule revision or issues a formal interpretation of the rule, S-X Rule 3-09 literally applies only to investments accounted for under the equity method (and unconsolidated subsidiaries). If an investment is accounted for using the FAS 159 fair value option, it would not fall within the scope of S-X Rule 3-09.

View B

Yes, S-X Rule 3-09 applies to an investment accounted for using the FAS 159 fair value option if it otherwise would be accounted for using the equity method under APB 18. If an investment meets the conditions to be accounted for under the equity method in APB 18, it falls within the scope of S-X Rule 3-09, even if the registrant elects to account for that investment under the SFAS 159 fair value option.

**SEC Staff Response:**

**The staff supports the applicability of Rule 3-09 by analogy.**

**SX 3-09 and SX 4-08(g) did not contemplate the fair value option. Those rules were put in place to provide presumptive disclosure thresholds for separate financial statements and/or summarized financial information of entities accounted for using the equity method, consistent with the requirements of APB Opinion 18, paragraphs 20d. The staff's experience has been that the SX 3-09 and SX 4-08(g) disclosure thresholds have helped registrants comply with the disclosure requirements of APB Opinion 18, paragraph 20d.**

**SFAS 159 requires, in part, that companies electing the fair value option for an investee comply with the disclosure requirements in APB Opinion 18, paragraph 20d. The staff believes that the disclosure thresholds in SX 3-09 and SX 4-08(g) provide analogous guidance for the SFAS 159 requirement to comply with the disclosure requirements of APB Opinion 18, paragraph 20d. However, in applying the SX 3-09 and SX 4-08(g) disclosure thresholds to investments that would have been accounted for under the equity method had the fair value option not been elected by the registrant, the staff believes that the income test should be computed using as the numerator the change in the fair value reflected in the registrant's income statement rather than the registrant's equity in the earnings of the investee computed as if the equity method had been applied. Also included in the numerator would be any gain/loss recorded by the registrant in its financial statements arising from a transaction in which a consolidated subsidiary becomes eligible for equity method accounting but will be accounted for under the fair value option.**

**If a registrant believes that applying the guidance in SX 3-09 and SX 4-08(g) as described above results in a requirement to provide more information than is reasonably necessary to inform investors, the staff encourages the registrant to pre-clear such matters in a written submission to the Office of the Chief Accountant in the Division of Corporation Finance.**

**The staff also cautions registrants that investees accounted for using the fair value option may be material at levels below the disclosure thresholds in SX 3-09 and SX 4-08(g). When investees accounted for using the fair value option are material to an understanding of results of operations, financial position, or cash flows, companies should consider whether qualitative and quantitative analysis in MD&A is required by SK 303, whether or**

**not separate financial statements and/or summarized financial information of an investee are provided. Specifically, companies should consider describing in MD&A the methods and underlying assumptions used in determining fair value, and analyzing the effects of any changes therein from the previous period(s). Companies should be mindful that such an analysis may be necessary even when material changes in significant assumptions have offsetting effects.**

**Question 2:** Does Rule 4-08(g) of Regulation S-X apply to an investment that is accounted for using the fair value option under SFAS 159 that otherwise would be accounted for using the equity method under APB 18?

**View A**

No, S-X Rule 4-08(g) is not applicable to an investment accounted for using the FAS 159 fair value option. Unless the SEC makes a technical rule revision or issues a formal interpretation of the rule, S-X Rule 4-08(g) literally applies only to investments accounted for under the equity method (and unconsolidated subsidiaries). If an investment is accounted for using the FAS 159 fair value option, it would not fall within the scope of S-X Rule 4-08(g). Notwithstanding the inapplicability of 4-08(g), the disclosure requirements of paragraph 18.f of FAS 159 must be satisfied.

**View B**

Yes, S-X Rule 4-08(g) applies to an investment accounted for using the FAS 159 fair value option if it otherwise would be accounted for using the equity method under APB 18. SFAS 159 requires the notes to the financial statements to include the summarized financial information specified in paragraph 20.d of APB 18 for investments that would have been accounted for under the equity method if the entity had not chosen to apply the fair value option. Notwithstanding that the investment is not, in fact, accounted for by the equity method, because S-X Rule 4-08(g) operationalizes the disclosure requirements of paragraph 20.d of APB 18, it should be extended to any investment that meets the conditions to be accounted for under the equity method in APB 18, even if the registrant elects to account for that investment under the SFAS 159 fair value option.

**SEC Staff Response: The staff supports the applicability of Rule 4-08(g) by analogy. See response to Question 1.**

**Question 3:** If View B applies to Question 1 and/or Question 2, how should a registrant calculate significance using the income test in Rule 1-02(w) of Regulation S-X for an investment that is accounted for using the fair value option under SFAS 159 that otherwise would be accounted for using the equity method under APB 18?

**View A**

Calculate the income test using the change in fair value recorded in the income statement. The amount recorded in the income statement is the best indication of the impact of the investment on the company's financial statements and is consistent with the historical method of using amounts actually reflected in the income statement to measure significance.

**View B**

Calculate the income test using the share of the investee's income that otherwise would be recorded under the equity method of accounting. The investee's financial information that would be disclosed in the notes to the financial statements under SFAS 159 is meant to provide

consistency of disclosure between those companies that use the fair value option and those that use the equity method of accounting.

**View C**

The income test is not applicable to an investment accounted for using the FAS 159 fair value option. For such investments, the registrant would not record any equity in the income of the investee. Therefore, in applying that significance test, the numerator would be zero and the income test would be effectively inapplicable.

**SEC Staff Response: The staff supports View A – see above.**