SEC Regulations Committee
Center for Audit Quality
October 11, 2007 - Joint Meeting with SEC Staff
SEC Offices — Washington DC

HIGHLIGHTS

NOTICE: The SEC Regulations Committee of the Center for Audit Quality meets periodically with the staff of the SEC to discuss emerging technical accounting and reporting issues relating to SEC rules and regulations. The purpose of the following highlights is to summarize the issues discussed at the meetings. These highlights have not been considered and acted on by senior technical committees of the AICPA, or by the Financial Accounting Standards Board, and do not represent an official position of either organization.

In addition, these highlights are not authoritative positions or interpretations issued by the SEC or its Staff. The highlights were not transcribed by the SEC and have not been considered or acted upon by the SEC or its Staff. Accordingly, these highlights do not constitute an official statement of the views of the Commission or of the Staff of the Commission.

I. ATTENDANCE

A. SEC Regulations Committee

John Wolfson, Chair
Chris Holmes, Vice Chair
Jack Ciesielski
Michael Cinalli
Brad Davidson
Melanie Dolan
David Follett
Bob Laux
Jeff Lenz
Steve Meisel
Scott Pohlman
Amy Ripepi
Kurtis Wolff

B. Securities and Exchange Commission

Office of the Chief Accountant

Paul Beswick, OCA, Senior Advisor
Adam Brown, Professional Accounting Fellow
Stephen Brown, Academic Fellow
Muneera Carr, Professional Accounting Fellow
Brian Croteau, Associate Chief Accountant

Jonathan Duersch, Assistant Chief Accountant
Julie Erhardt, Deputy Chief Accountant
Bert Fox, Professional Accounting Fellow
Len Jui, Associate Chief Accountant
Jim Kroeker, Deputy Chief Accountant
Jeff Minton, Chief Counsel
Zoe-Vonna Palmrose, Deputy Chief Accountant
K. Ramesh, Academic Fellow
Cheryl Tjon-Hing, Valuation Specialist
Brett Williams, Professional Accounting Fellow

Division of Corporation Finance

Craig Olinger, Deputy Chief Accountant
Louise Dorsey, Associate Chief Accountant
Paula Dubberly, Associate Director (Legal)
Stephanie Hunsaker, Associate Chief Accountant
Todd Hardiman, Associate Chief Accountant
Steven Jacobs, Associate Chief Accountant
Joel Levine, Associate Chief Accountant
Cheryl Linthicum, Academic Fellow
Leslie Overton, Associate Chief Accountant
Michael Stehlik, Staff Accountant
Sondra Stokes, Associate Chief Accountant

Division of Enforcement

Susan Markel, Chief Accountant

C. Center for Audit Quality

Annette Schumacher Barr

D. Guests

Jim Brown, BKD
Nedra Downing, D&T
Bridgette Hodges, Grant Thornton

II. STATUS UPDATE OF PROJECTS/ISSUES

A. Requirement to name valuation specialists as experts and obtain consents

Continuing the discussion from the July, 2007 meeting, the Committee asked the staff for its views regarding the need to name a specialist as an expert and obtain a consent. Particularly, the Committee asked whether a consent is required if the specialist (e.g., a valuation firm) is not specifically named and

if the filing does not contain a statement that the issuer has included information in reliance upon the report of such specialist. The staff stated although this issue has become more prevalent, the staffs position has remained unchanged: If a specialist is named or referred to generically, a consent is required. In response to further detailed questions regarding other types of references (e.g., consultation with legal counsel, actuaries, valuation experts, etc.), the staff replied that if there's a reference in any way, regardless of reliance, the staff will issue a comment requiring the registrant to name the expert and obtain a consent. The Committee and the SEC staff plan to further discuss the topic.

Regarding the wording of the consent, a specialist does not need to admit to being an "expert" but he/she cannot deny it. In addition, it would not be acceptable for the specialist to word the consent in a manner that would limit or disclaim liability.

B. Current Rulemaking Initiatives

- **IFRS acceptance without reconciliation**

  Julie Erhardt provided an update on the status of the Commission's recent proposal Acceptance From Foreign Private Issuers of Financial Statements Prepared in Accordance With International Financial Reporting Standards Without Reconciliation to U.S. GAAP. She stated that the staff is in the process of reading and summarizing the comment letter received on the proposing release (to date, 120 comment letters were received). In terms of the comments received, some did not support the elimination but the vast majority supported the elimination. A number of supporters expressed concerns regarding the timing of the elimination (questioning whether the SEC should eliminate the reconciliation now or wait for further convergence). Concerns were also raised regarding the implementation aspects of the proposal. In addition to the SEC's proposed option for an FPI to file based on the English language version of IFRS as published by the IASB, commenters proposed additional reporting options, such as (1) the acceptance of jurisdictional IFRS (e.g., EU IFRS) without reconciliation, (2) the acceptance of jurisdictional IFRS with reconciliation to IASB IFRS, and (3) the acceptance of any local GAAP with reconciliation to IASB IFRS.

  Ms. Erhardt stated that the staff has not established a timeline for finalizing the rulemaking process. Any open meetings to discuss final rulemaking will be announced in a Sunshine Act Notice on the SEC website.

- **Small Business Initiatives**

Craig Olinger provided an update on the status of the Commission's *Smaller Reporting Company Regulatory Relief and Simplification* proposal. He noted that the Commission has received 21 letters responding to the proposal, the majority of which expressed support. A timeline for the finalization of the proposed rules has not been established nor has a determination been made whether all of the small business proposals will be finalized together as a package or independently.

- Proxy Access

  Craig Olinger provided an update on the status of the SEC Shareholder Proposals and Shareholder Proposals Relating to the Election of Directors rulemakings. The Commission has received over 20,000 comment letters responding to these proposals. Although many of the letters received are form letters, there is significant and varying interest in these proposed rules. Chairman Cox has indicated that he would like the rules finalized in time for the coming proxy season.

C. Future Rulemaking Initiatives

- **Restatements and Item 4.02 of Form 8-K**

  Item 4.02 of Form 8-K currently requires that the company file a report within four business days of the triggering event of a decision that its past financial statements should no longer be relied upon. Because the rule does not specifically mention restatements, some issuers have chosen to disclose a determination that investors should no longer rely upon past financial statements into a periodic report rather than filing an 8K. As part of an update to its prior restatement study, the Government Accountability Office issued a recommendation that the Division improve the consistency and transparency of information provided to investors in this area.

  In a speech earlier this year, Division Director John White indicated that the Division is considering codifying the SEC staff position expressed in response to Question 1 of the 2004 Form 8-K FAQ in the instructions to Current Report on Form 8K; that is an Item 4.02 8-K must be filed – rather than just including that disclosure in a periodic report – any time a determination is made that the public should not rely on previously filed financial statements. In addition, the Division is also considering whether transparency might be promoted by a rule that required the filing of a Report on Form 8-K any time a company has determined to restate its financial statements.

  The staff indicated that no timetable has been set for the SEC's consideration in this area.

Voluntary Filers

The staff is currently looking at this area and considering whether voluntary filers should continue to be allowed to move in and out of the reporting system and whether voluntary filers must fully comply with all SEC disclosure requirements. This is an area of potential rulemaking.

- **XBRL**

The staff reported on the following recent developments relating to XBRL implementation:

Creation of US GAAP Taxonomies. On September 25, Chairman Cox announced the completion of all work on developing data tags for the entire system of U.S. generally accepted accounting principles. The taxonomies, which were created by the XBRL US Standards Consortium, are currently under review for GAAP compliance by the FAF (Financial Accounting Foundation). Critical stakeholder groups including analysts, public company preparers and software providers will also be reviewing the draft taxonomies before a broad-based public review is initiated.

Formation of Office of Interactive Disclosure. On October 9 the SEC announced the creation of a new office to lead the transformation to interactive financial reporting by public companies. The Office of Interactive Disclosure will be led by David Blaszkowsky, an 11-year veteran of McGraw-Hill, whose career includes seven years with the firm's Standard & Poor's division.

The staff is working to draft a report on the possible mandate of XBRL data tagging in SEC reports. The staff will consider the appropriate scope of data tagging within filings (e.g., primary financial statements, note disclosures), the scope of any initial requirement (e.g., certain large accelerated filers), and effective dates for transition. The SEC is expected to consider its staffs report and potential rulemaking in the spring of 2008.

It was also noted that The XBRL Assurance task force of the AICPA Assurance Services Executive Committee is assessing the assurance implications of reporting in XBRL format. The task force is observed by SEC and PCAOB representatives and has liaisons to both the CAQ Professional Practices Executive Committee (PPEC) and the AICPA Auditing Standards Board (ASB).

- **Climate Change Risk Disclosures**

The Committee asked the staff whether there are any plans to issue guidance in response to a recent *Petition for Interpretive Guidance on*

Climate Risk Disclosure. The staff stated that it is currently considering the need for any guidance in this area.

D. Recent/Pending Accounting, Disclosure and SEC Rule Changes

- **FIN 48**

  The staff indicated that they were not aware of any new implementation questions or issues.

- **SAB 108**

  The staff indicated that they were not aware of any new implementation questions or issues.

- **Executive Compensation/CDA Disclosures**

  On October 9 the Commission staff published a report discussing the principal themes that emerged from its initial review of the disclosure of 350 public companies for compliance with the Commission's new and enhanced rules for executive compensation and related disclosure. The staff report is available at http://www.sec.gov/divisions/corpfin/guidance/execcompdisclosure.htm

  Paula Dubberly noted that these executive compensation reviews are dialogues in which companies have an opportunity to discuss comments with which they don't agree and/or areas they believe aren't applicable. She also noted that CDA disclosures were addressed in a recent speech by John White (expressing concern regarding missing analysis in the first year's CD&A) as well as a speech by Chairman Cox (advocating the use of "plain language").

- **FAS 157 and FAS 159**

  Jim Kroeker said that the SEC staff had not yet received many formal consultation requests related to the new fair value standards. He also observed that the detailed nature of questions relating to FAS 157 implementation raised at the initial meeting of the FASB's new Valuation Resource Group indicates that practitioners are still operating with a rule-based mindset. He emphasized that the application of judgment is very important to the proper implementation of the principles in FAS 157.

  Mr. Kroeker noted that the FASB has received numerous requests for a deferral of FAS 157 implementation dates and added that any deferral could have implications to the effective dates of other standards such as FAS 159, SOP 07-1, etc. *[Note: On October 17, 2007, the FASB voted NOT to defer FAS 157 in its entirety, but might consider deferring the effective date for specific provisions.]*

- **Foreign Private Issuer Deregistration and Auditor Independence Considerations**

  Background: Under the new SEC deregistration rules, a foreign private issuer may apply for deregistration by filing Form 15F. This automatically suspends the registrant's Exchange Act reporting obligations and triggers a 90-day waiting period at the end of which, assuming the SEC has no objections, the registrant's Exchange Act reporting obligation terminates. It is possible that the SEC could object to a registrant's request for deregistration or that the registrant might withdraw its application. In these circumstances, within 60 days of the date of the denial or withdrawal, the issuer must submit all reports that otherwise would have been required. The issuer would then continue as a registrant with the SEC and be subject to the PCAOB independence rules.
  Question: What is the SEC's experience and expectations regarding rejecting requests for deregistration? A rejection could affect independence determinations by the auditors and the need to provide further audit services under U.S. GAAS.
  Staff Response: Since the new deregistration rules were issued in June, several foreign private issuers have applied for deregistration and none were rejected. Mr. Olinger stated that the intent of the rule is to allow deregistering; the staff does not want to impede this intent by denying applications for deregistration. However, if the Staff sees an inconsistency with an FPI's compliance with the criteria for deregistration, they might question the application.

E. Advisory Committee on Improvements to Financial Reporting

The staff provided an overview of the SEC Advisory Committee on Improvements to Financial Reporting. The advisory committee will focus on the following areas before making recommendations to the Commission:

- the current approach to setting financial accounting and reporting standards;
- the current process of regulating compliance by registrants and financial professionals with accounting and reporting standards;
- the current systems for delivering financial information to investors and accessing that information;
- other environmental factors that drive unnecessary complexity and reduce transparency to investors;
- whether there are current accounting and reporting standards that impose costs that outweigh the resulting benefits, and

- whether this cost-benefit analysis is likely to be impacted by the growing use of international accounting standards.

The advisory committee held its first meeting on August 2 and its next meeting is scheduled for November 2. The meeting will be open to the public and will also webcast on the SEC website at www.sec.gov.

F. Committee recommendations for Staff speech topics at SEC Conference

- The Committee agreed to provide speech topics as soon as practicable.

G. Status of Publication Projects and Other Initiatives

The Committee and staff indicated that there were no developments to update for the following projects/initiatives:

- Staff Training Manual
- Alerts to be issued by the Division of Corporation Finance or Office of the Chief Accountant
- Current Accounting and Disclosures Issues (last update — 11/30/06)
- Compilation of Joint Meeting Highlights

H. Personnel Changes

The staff noted the following personnel changes:

Office of the Chief Accountant
Steven Brown, Academic Fellow
Jeff Minton, General Counsel
Paul Beswick, Senior Advisor
Jeff Ellis, Professional Accounting Fellow
Burt Fox, Professional Accounting Fellow
Adam Brown, Professional Accounting Fellow
Bret Williams, Professional Accounting Fellow

Division of Corporation Finance
Cheryl Linthicum, Academic Fellow

Division of Investment Management
Toai Cheng has left the Commission and the Division of Investment Management will be hiring a replacement this fall.

Division of Enforcement
The Division of Enforcement had one job opening this summer. The posting has now closed and it is expected that the new position will soon be filled.

Office of Interactive Disclosure

David Blaszkowsky will lead this newly created office.

III. SPECIFIC PRACTICE ISSUES — DISCUSSION DOCUMENTS

The following emerging practice issues were addressed at the meeting:

Current Practice Issues

A. Assessing the Age of Financial Statement Requirements Relating to an Acquired/To Be Acquired Business When the Registrant and the Acquiree Have Different Fiscal Year-Ends

B. Financial Information Required in Registration Statements When there are Retrospective Accounting Changes as a Result of Eventual Adoption of Proposed FASB Staff Position ABP 14-a

C. 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

Committee Documents Previously Provided to the Staff

D. Application of Rules 3-10 and 3-16 of Regulation S-X to Automatic Shelf Registration Statements (based on November 2006 meeting with the staff; draft sent to staff on December 11, 2006)

E. Financial Statements of Credit Enhancers and Related Accountants' Consents in Filings by Asset-Backed Issuers (Sent on July 31, 2006) *[OPEN]*

F. Application of Rules 3-09 and 4-08(g) of Regulation S-X to Investments Accounted for Using the Fair Value Option under SFAS No. 159 that Otherwise Would be Accounted for Under the Equity Method under APB 18 (Document E from the July 2007 meeting)

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Discussion Document A

Topic: Assessing the Age of Financial Statement Requirements Relating to an Acquired/To Be Acquired Business When the Registrant and the Acquiree Have Different Fiscal Year-Ends

Issue: How should a registrant determine its eligibility under Rule 3-01(c) of Regulation S-X for purposes of evaluating financial statement updating requirements relating to a significant acquired/to be acquired business with a fiscal year-end that differs from the registrant's fiscal year-end?

Background: The historical financial statements of a significant acquired/to be acquired business included in a new or amended registration statement do not need to include audited financial statements for the acquiree's most recently completed fiscal year if the registration statement is filed (or becomes effective) on or before the 45th day after the acquiree's fiscal year-end. The SEC Staff Training Manual also indicates (at page 2-20) that the registration statement does not need to include the acquiree's audited financial statements for its most recently completed fiscal year if the registration statement is filed (or becomes effective) after 45 days but within 90 days of the acquiree's fiscal year end and the registrant meets the eligibility requirements under Rule 3-01(c) of Regulation S-X.

> Note: The reference to 90 days above assumes the acquiree is either a private company or a non-accelerated filer. If the acquiree is an accelerated filer or a large accelerated filer, the reference would be changed to 75 days or 60 days, respectively.

The eligibility criteria set forth in Rule 3-01(c) are as follows:

1. The registrant files annual, quarterly and other reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 and all reports due have been filed;

2. For the most recent fiscal year for which audited financial statements are not yet available the registrant reasonably and in good faith expects to report income, after taxes but before extraordinary items and cumulative effect of a change in accounting principle; and

3. For at least one of the two fiscal years immediately preceding the most recent fiscal year the registrant reported income, after taxes but before extraordinary items and cumulative effect of a change in accounting principle.

Consider the following example:

Company X is a calendar year-end SEC registrant and has filed all reports due pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

Company X purchased Business B (a private company with a March 31 fiscal year-end) on April 15, 2007 in an all-cash transaction. Company X has determined that Business B is significant at the 80% level.

Company X intends to file a new registration statement on Form S-3 on May 21, 2007. Business B's audited financial statements for the year-ended March 31, 2007 will not be available at the date the Form S-3 is intended to be filed.

Question: How should Company X evaluate criteria #2 and #3 of Rule 3-01(c) for purposes of determining whether the Form S-3 must include/incorporate by reference audited financial statements of Business B for its fiscal year-ended March 31, 2007?

View A: Company X's eligibility under Rule 3-01(c) should be measured by reference to its most recently completed fiscal year (without regard to whether the audited financial statements for that year have been issued) and the two preceding fiscal years. Since Company X's most recently completed fiscal year-end is the year ended December 31, 2006, Company X should use its actual income after taxes but before extraordinary items and cumulative effect of a change in accounting principle for the year ended December 31, 2006 for purposes of evaluating criterion #2. Company X should use its actual income after taxes but before extraordinary items and cumulative effect of a change in accounting principle for the years ended December 31, 2005 and 2004 for purposes of evaluating criterion #3.

View B: Company X's eligibility under Rule 3-01(c) should be based on the financial statements for the next fiscal year for which financial statements will be issued (as well as the two preceding fiscal years). Since the year-ending December 31, 2007 is the next fiscal year for which financial statements have not yet been issued, Company X should use its best estimate of its projected income after taxes but before extraordinary items and cumulative effect of a change in accounting principle for the year ending December 31, 2007 for purposes of evaluating criterion #2. Company X should use its actual income after taxes but before extraordinary items and cumulative effect of a change in accounting principle for the years ended December 31, 2006 and 2005 for purposes of evaluating criterion #3.

View C: Since Company X has filed its audited financial statements for its most recently completed fiscal year, the tests for criteria #2 and #3 should be made by reference to Business B's financial information. Business B should use its expected income after taxes but before extraordinary items and cumulative effect of a change in accounting principle for the year ended March 31, 2007 for purposes of evaluating criterion #2. Business B should use its actual income after taxes but before extraordinary items and cumulative effect of a change in accounting principle for the years ended March 31, 2006 and 2005 for purposes of evaluating criterion #3.

View D: Since Company X has filed its financial statements for the most recent fiscal year, the tests in Rule 3-01(c) are no longer applicable and therefore Business B's financial statements must always be updated to include audited financial statements for its year ended March 31, 2007. As indicated in the SEC Staff Training Manual, if the registrant believes the requirement to provide audited financial statements more current than the audited financial statements of the registrant, registrants could seek relief from the audit requirement since this method of evaluation would required audited financial statements of the target that are more recent than the audited financial statements of the registrant.

Committee Recommendation: The Committee supports View A. The Committee believes the most recently completed fiscal year of the registrant should be the starting point of the analysis without regard to whether those financial statements have been issued. The Committee believes this model would avoid the need for the registrant to project its income for a significant amount of time.

SEC Staff Response: The staff supports View A.

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Discussion Document B

Topic: Financial Information Required in Registration Statements When there are Retrospective Accounting Changes as a Result of Eventual Adoption of Proposed FASB Staff Position APB 14-a

Background:

Proposed FASB Staff Position APB14-a addresses the accounting for convertible debt instruments that, by their stated terms, may be settled in cash (or other assets) upon conversion, including partial cash settlement, unless the embedded conversion option is required to be separately accounted for as a derivative under Statement 133. The FSP, as proposed, would be effective for financial statements issued for fiscal years beginning after December 15, 2007, and interim periods within those fiscal years. The FSP, as proposed, would be applied retrospectively to all periods presented, and the transition disclosures in paragraphs 17 and 18 of Statement 154 would be provided.

If the FSP is issued as proposed, it will raise issues related to the appropriate financial reporting and disclosure a) in registration statements filed prior to the registrant filing its first interim period financial statements reflecting the adoption of the proposed FSP, and b) in registration statements filed after the registrant files its first interim period financial statements reflecting the adoption of the proposed FSP.

The same issues were discussed in Discussion Document F for the AICPA SEC Regulations Committee's June 20, 2006, Joint Meeting with the SEC Staff in relation to FASB Statement 123(R), which permitted companies to adopt its provisions via modified retrospective application, and Statement 154, which requires companies to report a change in accounting principle through retrospective application. The "Background" section to that Discussion Document included citations from relevant literature and a variety of alternative views to be considered.

As a result of the SEC Staff previous views expressed at that meeting, this Discussion Document simply recasts the questions from June 2006 Discussion Document F to serve as a confirmation that the same approach would apply in this case.

Question 1:

Once FSP APB 14-a is issued and a company must make an accounting change that requires retrospective treatment in its financial statements, what financial information regarding the effects of these changes on previously issued financial statements should be included or incorporated by reference in a registration statement filed prior to filing the first interim period financial statements reflecting the adoption of the FSP?

Committee Recommended Approach:

Disclosure of the impending change consistent with SAB 74 is sufficient. This should include appropriate disclosure if the company knows the impact of adoption of the FSP as issued. There is no requirement to provide more extensive information until the accounting change has been reflected in historical financial statements.

SEC Staff Position:

The staff supports the approach recommended by the Committee.

Question 2:

Once FSP APB 14-a is issued and a company makes an accounting change that requires retrospective treatment in its financial statements, what financial information regarding the effects of these changes on previously issued annual financial statements should be included in a registration statement filed or amended after filing the first interim period financial statements reflecting the adoption of the FSP? Would the conclusion be different if the previously issued annual financial statements are incorporated by reference, rather than included?

Committee Recommended Approach:

Provide revised audited financial statements reflecting the accounting change.
Item 11 of Form S-3 requires inclusion of restated financial statements if there has been a change in accounting principle where such change or correction requires a material retroactive restatement of financial statements. This approach is also required by Statements 144, 131, 123(R) and 154. Note that the conclusion would not be different if the previously issued financial statements are incorporated by reference, rather than included.

SEC Staff Position:

The staff supports the approach recommended by the Committee.

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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.

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Discussion Document D

Topic: Application of Rules 3-10 and 3-16 of Regulation S-X to Automatic Shelf Registration Statements

Background: Company X is a calendar year-end, well-known seasoned issuer with a reporting obligation under Section 13(a) of the Exchange Act. In order to be in a position to respond quickly to market conditions, Company X has determined to file an automatic shelf registration statement on Form S-3 to register the offer and sale by one of its subsidiaries (Subsidiary A) of an unspecified amount of debt securities. Subsidiary A (an operating subsidiary) is not otherwise an SEC registrant.

The prospectus that is included in the Form S-3 states that the debt securities being registered may be guaranteed by Company X and some, but not all, of Company X's direct and indirect subsidiaries. These subsidiaries are listed as additional registrants in the automatic shelf registration statement. Subsidiary A and all of the named guarantor subsidiaries are 100% owned, the guarantees will be full and unconditional and joint and several. The non-guarantors are more than minor.

Although a number of subsidiaries will be named in the registration statement as guarantors, the debt issued by Subsidiary A may ultimately be guaranteed by less than all of the named subsidiary guarantors. The final list of guarantors will be named in a prospectus supplement at the time of a takedown.

Question 1: Rule 3-10(a) of Regulation S-X states:

> "Every issuer of a registered security that is guaranteed and every guarantor of a registered security must file the financial statements required for a registrant by Regulation S-X."

What financial statements must be included or incorporated by reference in the automatic shelf registration statement at the time it is filed (i.e., at the effective date)?

View A: Because the actual composition of the group of subsidiary guarantors that will guarantee a particular security may not be known when the automatic shelf registration statement is filed, Subsidiary A and the guarantor subsidiaries are not required to provide financial statements in the automatic registration statement at the time it is filed.

Subsidiary A and the guarantor subsidiaries would, however, be required to provide the required financial statements prior to the actual sale of any guaranteed debt securities (i.e., in a shelf takedown). The financial statements provided at the time of the takedown should comply with Regulation S-X (e.g., Rule 3-10(d)) and may be provided by filing a post-effective amendment to the registration statement, by filing them in an Exchange Act report that is incorporated by reference in the registration statement or by providing them in a prospectus supplement.

Supporters of View A note that it is broadly consistent with the guidance provided in Question 25 of the DCF Staffs November 30, 2005 *Securities Offering Reform Questions and Answers.* The staff's answer to Question 25 indicated that for purposes of complying with Rule 3-10(g) of Regulation S-X, the test would not be made until an actual sale of a security takes place.

Supporters of View A do not believe that compliance with Rule 3-10 before the time that any guaranteed securities are actually sold would provide much in the way of meaningful and incremental investor protection. However, it would clearly result in additional costs to the issuer(s). Supporters of View A also believe that the same answer would apply even if the shelf registration statement were not an "automatic" shelf registration statement.

View B: The debt being registered is a security to be offered and sold by Subsidiary A. The guarantees of that debt by Company X and by the guarantor subsidiaries are also securities that are being registered. Therefore, the automatic shelf registration statement must include (or incorporate by reference) financial statements of the issuer (Subsidiary A) and each of the guarantors unless they are otherwise exempt from this requirement. Additionally, upon filing the automatic shelf registration statement, Subsidiary A and all of the guarantor subsidiaries will attract a reporting obligation under Section 15(d) the Exchange Act unless otherwise exempt from this requirement.

The only exemption available to Subsidiary A and the guarantor subsidiaries listed in the automatic shelf registration statement from the requirements of the Securities Act to provide financial statements in the automatic shelf registration statement would be to comply with Rule 3-10(d) of Regulation S-X. Compliance with Rule 3-10(d) would require that Company X's financial statements included or incorporated by reference in the automatic shelf registration statements include the condensed consolidating financial information specified by Rule 3-10(d)(4). This is true even though Subsidiary A has no current plans to issue the debt securities and even though the group of subsidiary guarantors may ultimately change. Compliance with Rule 3-10(d)(4) should continue in Company X's future periodic reports as well. This will provide Subsidiary A and the guarantor subsidiaries with an exemption from Exchange Act reporting through Exchange Act Rule 12h-5(a). At the time of an actual sale of guaranteed securities, Company X should evaluate its compliance with Rule 3-10 and should provide any additional financial statement disclosures that would be necessary (e.g., an alternative set of condensed consolidating financial information if not all of the subsidiary guarantors listed in the automatic shelf registration statement guarantee the debt to be issued).

Committee Recommendation: The Committee favors View A as a more practical approach that is consistent with investor protection. The Committee does not believe investors need financial information about potential subsidiary issuers or guarantors for securities that have not yet been offered for sale. However, absent relief, it appears to the Committee that the literal application of existing SEC rules and regulations would require Rule 3-10 information upon the initial filing of a shelf registration statement, consistent with View B.

SEC Staff Position: **The Staff takes View B and notes that the answer would be the same even if the shelf registration statement was not an automatic shelf registration statement. When the registration statement becomes effective, the subsidiary issuer/guarantors become registrants and have separate Exchange Act reporting obligations unless they are otherwise exempt. This is true even though securities are not yet issued under the registration statement. In order to qualify for an exemption from Exchange Act reporting under Rule 12h-5, the subsidiary issuer/guarantors would need to be permitted to omit financial statements by Rule 3-10. That omission is conditioned on the parent company providing the financial information (e.g., condensed consolidated financial information) specified by Rule 3-10(b)-(f), as applicable.**

The Staff also stated that a post-effective amendment and information required by Rule 3-10 would be required if, after the effective date, a pre-existing subsidiary (or a newly formed entity into which pre-existing assets were transferred) is added as a guarantor.

Additional Background: Company X's automatic shelf registration statement also will register the offer and sale by Company X of an unspecified amount of non-convertible senior debt that will

be collateralized by the stock (held by Company X) of Company X's domestic subsidiaries (including Subsidiary A).

Question 2: Rule 3-16 of Regulation S-X states that securities constitute a "substantial portion of the collateral" for any class of securities registered or being registered if the greatest of (i) the aggregate principal amount, (ii) par value or (iii) book value of the securities as carried by the registrant, or (iv) the market value of such securities equals 20% or more of the principal amount of the secured class of securities. How should Company X perform this analysis in connection with the automatic shelf registration statement being filed?

View A: Because the amount of collateralized securities to be issued is not known at the time that the automatic shelf registration statement is filed, Company X need not comply with Rule 3-16 at that time. This is also the case if Company X files a Form 10-K after the time that the automatic shelf registration is filed but before an actual sale of collateralized debt. At the time of a specific sale of collateralized debt, Company X must perform the Rule 3-16 analysis. Any financial statements required by Rule 3-16 at the time of the takedown may be provided by filing a post-effective amendment to the registration statement, by filing them in an Exchange Act report that is incorporated by reference into the registration statement or by providing them in a prospectus supplement.

Supporters of View A do not believe that compliance with Rule 3-16 before the time that any collateralized securities are actually sold would provide much in the way of meaningful and incremental investor protection. However, it would clearly result in additional costs to the issuer(s). Additionally, supporters of View A note that it is broadly consistent with the guidance provided in Question 25 of the DCF Staff's November 30, 2005 *Securities Offering Reform Questions and Answers.* The staff's answer to Question 25 indicated that for purposes of complying with Rule 3-10(g) of Regulation S-X, the test would not be made until an actual sale of a security takes place. Supporters of View A believe that the same answer would hold even if the registration statement were for a specified amount of securities (e.g., registering the offer and sale of up to $500 million of collateralized debt).

View B: Because Company X cannot determine to exclude any of the entities from the 3-16 analysis, it should presume that they will be required and should provide financial statements pursuant to Rule 3-16 in the automatic shelf registration statement as well as any subsequently filed Form 10-Ks. At the time that Company X sells collateralized debt, it should perform the Rule 3-16 test based on the principal amount of the securities sold and may stop providing Rule 3-16 financial statements for any subsidiaries that don't meet the test at the time that the securities are sold.

Committee Recommendation: The Committee supports View A.

SEC Staff Position: The Staff takes View A and notes that a distinguishing feature between Questions 1 and 2 is that in Question 1, the subsidiary issuer/guarantors are separate registrants under the Securities Act of 1933. In Question 2 the subsidiaries are not separate registrants.

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 staffs 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.