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Office of the Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Request for Comment on the Effectiveness of Financial Disclosures about Entities Other than the Registrant; File No. S7-20-15

Dear Office of the Secretary:

The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors, convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocates policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, D.C., the CAQ is affiliated with the American Institute of Certified Public Accountants.

The CAQ commends the Securities and Exchange Commission (SEC or Commission) for its efforts to improve and enhance disclosures by systematically reviewing the disclosure requirements in the Commission's rules and forms. We believe the Commission has taken an important first step by closely considering the requirements in Regulation S-X (S-X) applicable to certain entities other than the registrant. We appreciate the opportunity to share our views and provide input on the areas included in the *Request for Comment on the Effectiveness of Financial Disclosures about Entities Other than the Registrant* (Request for Comment).

We recognize that the principal purpose of disclosure is to provide material information to investors to aid them in making investment and voting decisions. We believe the areas addressed in the Request for Comment are important to consider as they often require extensive disclosure and financial information, and they have not been reconsidered in several years. In their experience working with public companies in the capital markets, CAQ member firms have observed circumstances where the requirements of these rules may affect a company's ability to access capital or negotiate transactions. We have not conducted outreach to the investor community as a part of our recommendations; however, consistent with recent remarks by Chair Mary Jo White,¹ we agree that investors' views regarding how they utilize the financial information required by the existing rules will be key to ensuring the resultant requirements serve investors' needs in a timely manner without unnecessary compliance costs. We encourage the SEC to continue its outreach to investors, preparers, and other constituency groups in its consideration of feedback received on the Request for Comment.

1 Keynote Address at the 47th Annual Securities Regulation Institute: "[Building a Dynamic Framework for Offering Reform](#)"

In developing the CAQ's observations and recommendations in this letter, we have considered the following areas:

- Rules that require disclosure of information that may not be material from which companies currently seek and often obtain various forms of relief from the SEC staff (e.g., anomalous results in significance tests, the use of abbreviated financial statements, and the provision of expanded footnote disclosure in lieu of separate financial statements for equity method investees).
- Requirements that may be overly complex and prescriptive for which simplification or other revisions could result in information that is either comparable or more meaningful for investors (e.g., pro forma financial information under S-X Article 11 and financial information/statements required by S-X Rule 3-10 and S-X Rule 3-16).
- Requirements with inconsistencies in the level of information provided to investors under the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act) (e.g., probable acquisitions, individually insignificant acquisitions, and the application of S-X Rule 3-10(g)) or certain inconsistencies among rules that appear to have no valid basis (e.g., S-X Rule 3-14 vs. S-X Rule 3-05, and the number of periods required under S-X Rule 3-05 for different categories of registrants).

In formulating each of our suggestions, we have avoided recommending quantitative thresholds or specifying the exact form and content of the suggested disclosures as we believe such determinations should consider the input of registrants, users and investors. We respectfully submit the observations of the CAQ based upon our professional experience with each of these topics, but note that they are not necessarily the views of any specific firm, individual or CAQ Governing Board member. In this letter, we offer for the Commission's consideration our views regarding the issues raised in the Request for Comment, organized into the following sections:

- I. Significance tests (S-X Rule 1-02(w))
- II. Financial statements of acquired or to-be-acquired businesses and real estate operations (S-X Rules 3-05 and 3-14, respectively)
- III. Pro forma financial information requirements for acquisitions and dispositions (S-X Article 11)
- IV. Financial information of equity method investees (S-X Rules 3-09 and 4-08(g))
- V. Financial statements of guarantors or issuers of guaranteed securities registered or being registered (S-X Rule 3-10)
- VI. Financial statements of affiliates that collateralize registered securities (S-X Rule 3-16)
- VII. Consideration of XBRL tagging in other entity financial statements

As possible amendments to Regulation S-X are considered, the Commission should consider the benefit of addressing possible proposed rules changes by topic and not necessarily collectively.

I. Significance tests (S-X Rule 1-02(w))

The significance tests set forth in S-X Rule 1-02(w) employ bright-line percentage thresholds to a limited set of financial statement measures that a registrant must apply to determine significance of a subsidiary. These tests are used in various SEC rules and regulations, including S-X Rules 3-05 and 3-09 when evaluating whether financial statements of other entities must be provided in SEC filings. In evaluating the appropriate framework for determining significance under S-X Rules 3-05, 3-09, and 4-08(g) and S-X Rule 11-01(b) we considered whether (1) a principles-based approach to determine significance is a preferable alternative to current bright-line thresholds, (2) the existing significance tests are appropriate for determining the extent of disclosures under the rules or (3) changes or alternatives to the tests should be made to reduce unnecessary complexity and further facilitate disclosure of useful information to investors.

While the introduction of a principles-based approach to determine significance has merit, we believe the use of objective tests to evaluate significance continues to be practical as it allows for clear application and execution across all SEC reporting companies. However, we believe there are limitations in the asset, investment and income tests as currently prescribed under S-X Rule 1-02(w). For example, the income test often yields anomalous results, requiring companies to seek waivers to omit financial statements that issuers

believe may not be material to investors. Further, the investment and asset tests are based on carrying amounts and do not necessarily consider the economic substance of the tested entity or its significance to the registrant. Finally, the investment test considers a mix of fair value and carrying amounts which may not yield meaningful results.

We believe the following changes to the significance tests in S-X Rule 1-02(w) should be considered:

Income test under S-X Rule 1-02(w)

The literal application of the income test can be challenging and often results in the requirement to provide financial statements that may not be material to investors, particularly when the registrant has near break-even results or when either entity has significant, unusual charges in the period tested. We believe the following metrics should be considered as substitutes for the income test as currently defined.

- Revenues – compare the registrant’s proportionate share of net revenues of the tested entity to the registrant’s consolidated net revenues for the most recently completed fiscal year.
- Pro forma revenues – to be used as the numerator and/or denominator when respective pro forma financial information has been filed for the most recent fiscal year-end under S-X Article 11.

We believe the suggested alternatives are better indicators of significance based on operations and would not result in as many anomalous results as are yielded by the current income test.

If, based on input from others (e.g., investors), the SEC decides to retain the income test as currently defined in S-X Rule 1-02(w), we recommend a two-test approach to determine significance. For example, if the income test exceeds the applicable significance threshold (e.g., 20%), one of the other existing significance tests also should be met at some specified lower level (e.g., 10% or half of the applicable threshold) for the evaluated entity to be deemed significant. We believe this approach would limit the circumstances in which the income test alone results in an anomalous outcome regarding the significance of an evaluated entity that would require the provision of financial statements that may not be material or meaningful to investors. In addition, we also recommend modifying the Computational Note (2) of S-X Rule 1-02(w) to address the following when computing average income:

- Allow loss years to be excluded from the denominator in the calculation of average income (that is, four years of profitability would be divided by four, not five), or alternatively, the absolute value of loss years should be included in the computation of average income.
- Allow the use of average income for the tested entity included in the numerator (similar to what is permitted for the denominator).

Asset and investment tests under S-X Rule 1-02(w)

The existing asset and investment tests are largely based on carrying values and as a result do not necessarily measure the relative economic significance of the tested entity. Further, the calculation of the investment test compares a fair value metric (consideration transferred under U.S. Generally Accepted Accounting Principles (U.S. GAAP) or International Financial Reporting Standards (IFRS),² as appropriate) to a carrying value metric (total assets of the registrant) which may not provide a meaningful evaluation of significance. We believe the following single test should be considered as an alternative to the current investment and asset tests:

- Fair value test – compare the fair value of the registrant’s investment in the tested entity to the registrant’s fair value.

² For purposes of this letter, references to IFRS are in the context of the English language version of IFRS, as published by the IASB, unless otherwise noted.

- For the denominator, fair value amounts should be readily determinable for registrants with public equity outstanding. If a registrant does not have public equity outstanding and its fair value is not readily available, the carrying value of the registrant's total assets should be used in the denominator. In such circumstance, the carrying value of the registrant's investment would also be used in the numerator.
- For an equity method investment calculation under S-X Rule 3-09 or S-X Rule 4-08(g), the numerator should represent the fair value of the equity method investment. Carrying value would be used if fair value is not readily available. In such circumstances, the carrying value of the registrant's total assets should be used in the denominator similar to the investment test today.
- For purposes of S-X Rule 3-05, the numerator should continue to represent the fair value of the consideration transferred (that is, the purchase price under U.S. GAAP or IFRS, as appropriate).

Significance tests for an acquired business in an initial public offering (IPO)

The Commission's staff has recognized that IPOs involving businesses that have been built by aggregation were not contemplated in the drafting of S-X Rule 3-05 and as a result issued Staff Accounting Bulletin No. 80 (SAB 80), codified in SAB Topic 1.J.³ In practice, SAB 80 is not frequently applied because it is complex and limits the scope to businesses that remain identifiable after acquisition. In addition, the significance thresholds in SAB 80 were never updated to reflect the revisions to S-X Rule 3-05 made in 1996 when the SEC adopted the final rule, *Streamlining Disclosure Requirements Relating to Significant Business Acquisitions* (Release Nos. 33-7355; 34-37802). We recommend that if the Commission revises S-X Rule 3-05, that it address the objective of SAB 80 in a manner that will allow greater applicability and be consistent with the significance tests discussed above. For example, the rule should be modified to allow a comparison of the results of the target's revenues relative to pro forma revenue of the registrant and the fair value of target compared to the fair value of the issuer indicated by either the estimated IPO price or a recently determined fair value.

II. Financial statements of acquired or to-be-acquired businesses and real estate operations (S-X Rules 3-05 and 3-14, respectively)

In 1996, the SEC adopted the final rule noted above which reduced the regulatory burden of filing financial statements of significant acquisitions in Securities Act and Exchange Act filings. The SEC amended S-X Rule 3-05 by increasing the significance thresholds and limiting the requirement for financial statements of probable and recently acquired individually insignificant companies to only those filings involving a registered securities offering. As the Commission indicated, the revised rule was "intended to reduce impediments to registered offerings ... attributed to the inability of issuers to meet the registration disclosure requirement of providing audited financial statements of significant businesses acquired or likely to be acquired." While these changes were beneficial, we continue to observe these impediments where the application of the existing rules may have the unintended consequences of:

- Delaying the filing of the target's financial statements for all required periods along with pro forma financial information thereby delaying the timing of when investors obtain information to understand the effects of the transaction;
- Preventing or postponing capital formation transactions; or
- Deterring companies from completing acquisitions of private companies that could benefit investors because the issuer cannot obtain the necessary financial statements that are required by Commission rules.

We believe the disclosure requirements related to these transactions can be streamlined further as follows, while still providing investors with the useful information they need.

³ SAB 80 permits a company in an IPO to determine significance of acquired businesses based on pro forma amounts at the time of the registration statement if the company was built by the aggregation of businesses that remain substantially intact after the acquisition.

Number of periods

When an acquired business exceeds 50% significance, S-X Rule 3-05 generally requires three years of audited financial statements. Certain registrants, however, such as emerging growth companies (EGCs) and smaller reporting companies that are conducting IPOs are permitted to provide only two years of audited financial statements for both the registrant and its acquired businesses. In order to maintain appropriate balance in the disclosure requirements, we recommend that the Commission consider requiring only two years of audited financial statements for any acquisition, except in limited circumstances (e.g., predecessors, reverse acquisitions).

Alternatively, if the SEC retains the requirements for up to three years of audited financial statements for acquired businesses, we believe the Commission should consider increasing the significance threshold at which three years of audited financial statements would be required.

Enhancing consistency across issuers and filings

Individually insignificant acquisitions

We suggest that the Commission eliminate audited financial statement requirements for individually insignificant acquisitions. Currently, audited financial statements for the majority of individually insignificant acquisitions that exceed 50% significance in the aggregate are required only in registration statements, which makes it difficult for companies to anticipate whether they will ever need the information when negotiating the acquisition. We believe that these audited financial statements have minimal utility because they are limited to registration statements and only include select entities within a group which may be no more material than other entities for which separate financial statements are not provided.

Probable acquisitions

There are significant inconsistencies between the requirements for probable acquisitions in Securities Act and Exchange Act filings. In new or amended 1933 Act registration statements, three years of audited financial statements are generally required for a probable acquisition that exceeds 50% significance. However, in a take-down on a shelf registration statement, a registrant is only required to include financial statements of a probable acquisition if it represents a fundamental change. In addition, audited financial statements of probable acquisitions are required only in initial registration statements and in proxy statements, not in current or periodic reports. We encourage the SEC to consider alignment of the requirements for probable acquisitions. For example, the SEC may consider the following alternatives:

- Eliminate the financial statement requirements for probable acquisitions in Securities Act and Exchange Act filings.
- Require pro forma financial information (but not audited financial statements) for all significant probable acquisitions in Securities Act and Exchange Act filings.
- Require financial statements and pro forma financial information for probable acquisitions in Exchange Act reports in a manner (and thresholds) consistent with the Securities Act.

Abbreviated financial statements

We believe the use of abbreviated financial statements should be more broadly accepted in lieu of full financial statements. Currently, registrants must request SEC staff relief to provide abbreviated financial statements (i.e., statements of revenue and direct expenses and a statement of assets acquired and liabilities assumed), except for acquisitions of oil and gas properties or real estate acquisitions under S-X Rule 3-14. Developing and recording reasonable and auditable corporate cost allocations can be difficult and the value of such effort is questionable given that the acquired business will operate within a different corporate structure post-acquisition. The Commission should consider whether full U.S. GAAP financial statements should be required for an acquisition if they are not readily available, particularly in light of the extensive disclosures required to comply with U.S. GAAP and the treatment of S-X Rule 3-05 entities as Public Business Entities (PBEs) under U.S. GAAP. When full financial

statements are not available, we believe the registrant should be permitted to provide abbreviated financial statements if the registrant also provides appropriate disclosure about the reasons why abbreviated financial statements provide meaningful information to investors in lieu of full financial statements.

S-X Rule 3-14

We believe it is important to consider any revisions to S-X Rule 3-14 concurrently with changes to S-X Rule 3-05. When the SEC amended S-X Rule 3-05 in 1996, it deferred changes to S-X Rule 3-14 so that they could be done as part of a “more comprehensive disclosure scheme.” There are certain differences between S-X Rules 3-05 and 3-14 that the Commission should consider eliminating and, to the extent they have similar objectives, should consider aligning. Specifically, the SEC should consider aligning:

- The applicability of S-X Rule 3-06 (i.e., periods of 9 to 12 months satisfy the requirement to provide one year of financial statements);
- The use of audited pre-acquisition and post-acquisition periods to satisfy the disclosure requirement;
- The significance thresholds (i.e., 20% vs. 10%); and
- The requirements pertaining to individually insignificant acquisitions.

Investment company considerations

Investment companies, particularly business development companies (BDCs), may be formed through the acquisition of investment funds or a portion of the assets of investment funds. In these cases, the investment company may have limited historical information in its IPO registration statement, and S-X Rule 3-05 is used to determine whether financial statements, including a schedule of investments, of an acquired investment fund are necessary. First, we recommend the Commission consider a model in which significance is based on the pro forma results of a registrant when evaluating significance of investment funds acquired by investment companies. Second, we recommend considering whether audited financial statements of an acquired investment fund are necessary under these circumstances. We are aware that the staff has, in some circumstances, accepted an audited schedule of investments in lieu of audited financial statements of an acquired investment fund for certain investment company filings. We believe this information provides prospective investors with appropriate information to understand the likely composition of the newly formed investment company. Accordingly, we recommend that the SEC consider whether the provision of an audited schedule of investments under these circumstances would be sufficient for investment company IPOs.

Other suggestions

When audited financial statements of an acquired private company are available or are prepared solely for compliance with S-X Rule 3-05, significant incremental costs may be necessary to ensure the financial statements comply with the requirements of Regulation S-X (e.g., the form and content requirements in S-X Articles 4 and 5) as well as SEC staff accounting positions expressed in Staff Accounting Bulletins and EITF Observer comments (e.g., treatment of redeemable equity). In addition, this could delay the closing of a transaction or the ability of a registrant to provide more timely financial statements of an acquired company to investors. The Commission should consider whether the benefits of these requirements outweigh the costs.

In addition, an acquired entity that has applied private company accounting alternatives (e.g., goodwill or hedge accounting alternatives developed by the Private Company Council (PCC)) that qualifies as a PBE under U.S. GAAP solely because of S-X Rule 3-05 may need to retrospectively reverse its application of the PCC accounting and reporting alternatives for all periods presented. We encourage the SEC to consider an accommodation as contemplated in paragraph BC3 of Accounting Standards Update No. 2013-12 to accept private company alternatives in S-X Rule 3-05 financial statements, particularly for an entity without any ongoing reporting requirements such as a significant acquired business, given the accounting policies of that entity will be conformed to those of the registrant (which would be reflected in the pro forma financial information). For example, similar to the requirements for foreign businesses that prepare their financial statements on a basis other than U.S. GAAP or IFRS, an acquired private company following PCC alternatives could be permitted to discuss material variations

between the accounting principles used in preparing its financial statements and those used under U.S. GAAP for PBEs and Regulation S-X or quantify certain balance sheet and net income differences.

In a cross-border transaction, financial statements of the acquired business must be prepared in accordance with U.S. GAAP or include an extensive reconciliation under Item 18 of Form 20-F unless the acquired company meets the definition of a foreign business under S-X Rule 1-02(l). If audited financial statements prepared in accordance with IFRS are otherwise available, requiring financial statements in accordance with U.S. GAAP may result in unnecessary costs and information that may not be useful to investors if the financial statements of the registrant are not prepared in accordance with U.S. GAAP. We believe that the SEC should consider expanding the instances in which an entity that does not qualify as a foreign business (other than the registrant) could provide financial statements in accordance with IFRS if U.S. GAAP financial statements are not readily available. At a minimum, if a foreign private issuer files its financial statements in accordance with IFRS, we believe that the financial statements of an acquired business should be permitted to comply with IFRS (or reconcile home-country GAAP financial statements to IFRS) even if it does not qualify as a foreign business, because financial reporting by such entities on a basis consistent with the registrant would seem to be more useful for investors. We also recommend that the SEC consider accepting audits of financial statements of acquired foreign companies performed in accordance with International Standards on Auditing (ISAs). ISAs are high-quality auditing standards that are widely accepted worldwide and largely converged with AICPA standards.

III. Pro forma financial information requirements for acquisitions and dispositions (S-X Article 11)

Definition of a Business

Because the objectives of the definition of a business for purposes of S-X Rule 11-01(d) and the current applicable accounting standards are different, we do not believe that it is necessary for the Commission to align the two definitions of a business. The objective of Article 11 is to require disclosure of prior financial information when it is “material to an understanding of future operations.” We think this is the right objective. To determine whether pre-acquisition financial statements are needed, S-X Article 11 focuses on whether there is sufficient continuity of the acquired entity’s operations (particularly the nature of the revenue-producing activity). Unlike S-X Article 11, the definition of a business in the current applicable accounting standards contemplates whether inputs, processes and outputs exist *at the acquisition date* without considering whether they will continue *after* the acquisition date. Moreover, outputs are not required. Therefore, although they are not common, situations can occur where an integrated set of activities is considered a business under U.S. GAAP but the pre-acquisition financial statements are not material to an understanding of the acquirer’s future operations. Examples include situations where the acquirer will use the acquired assets internally or the acquired business has not yet produced outputs (but as of the acquisition date is capable of producing them). Providing pre-acquisition financial statements in these situations would be inconsistent with the objective of S-X Article 11.

We also note that the FASB is currently engaged in a project to clarify the definition of a business under U.S. GAAP. If the Commission is inclined to use the U.S. GAAP definition of a business, we believe it would be appropriate to wait until the FASB completes its project before making a decision.

Usefulness of Pro Forma Information

We understand that investors are keenly interested in information that communicates the effects of significant events on a registrant, such as pro forma information. As discussed below, the Commission could potentially improve pro forma financial information by addressing: (1) differences between U.S. GAAP and S-X Article 11 presentations; (2) the time periods for which information is presented; and (3) the types of adjustments allowed.

Consistency with U.S. GAAP requirements

Both U.S. GAAP (ASC 805-10-50-1) and S-X Article 11 require disclosure of pro forma financial information. For various reasons, pro forma operating results giving effect to business combinations may be different under each requirement. For example:

- Nonrecurring adjustments – S-X Article 11 prohibits income statement adjustments for nonrecurring charges or credits directly attributable to a transaction. U.S. GAAP requires these adjustments.
- Different assumed transaction dates – S-X Article 11 requires adjustments related to a pro forma income statement to be computed assuming the transaction was consummated at the beginning of the fiscal year presented. In contrast, the assumed acquisition date used to compute pro forma operating results in accordance with U.S. GAAP is not revised as the financial statements are updated.⁴ These differences cause S-X Article 11 pro forma operating results that might initially agree with the U.S. GAAP pro forma operating results to move out of alignment as time passes.⁵
- Different earnings measures – S-X Article 11 requires pro forma income from continuing operations and related pro forma per share amounts, and it prohibits showing pro forma amounts reflecting discontinued operations. U.S. GAAP simply requires a company to present pro forma “earnings” and does not specify which “earnings” measure is to be presented.⁶

We recommend that the Commission coordinate with the FASB to establish more consistency between the pro forma presentation requirements.

Permitting pro forma income statements for more than one year

S-X Rule 11-02(c)(2)(i) requires a registrant to present a pro forma income statement for the most recent fiscal year and subsequent interim period for a business combination. We note that the SEC staff has informally indicated that they will not object if a registrant presents pro forma comparative prior year interim income statement information.⁷ ASC 805-10-50-2(h) requires two years of pro forma income statement information when comparative financial statements are presented. Consistent with our recommendations above for promoting consistency between S-X Article 11 and U.S. GAAP pro forma disclosures, we recommend that a registrant be permitted, at its discretion, to present S-X Article 11 pro forma income statement information for two years if it believes the presentation would provide investors with more useful information. Such presentation could also facilitate useful comparative analysis for investors in Management’s Discussion and Analysis.

Restrictions on pro forma adjustments

In considering what adjustments should be permitted in preparing pro forma information, the Commission should consider the objectives of preparing information that is (1) consistently prepared and reliable and (2) useful in analyzing the future prospects of a registrant. As the Commission acknowledges in the Request for

4 ASC 805-10-50-2.h.

5 To illustrate, assume a registrant with a December year end acquires a business in late 2015, and a significant portion of the purchase price is for an intangible asset for which an accelerated method of amortization will be used. When Article 11 pro forma information is first prepared to report the business combination (for example, in a Form 8-K reporting the acquisition), the assumed acquisition date will be the same for Article 11 and U.S. GAAP – January 1, 2014. Thus the 2014 pro forma amortization expense will be the same in the 2014 Article 11 pro forma statement of income and the 2014 U.S. GAAP pro forma operating results reflected in the footnotes to the registrant’s financial statements in its 2015 Form 10-K. Assume the registrant files a registration statement in late 2016. At that time, it is required to update its Article 11 pro forma information and present a pro forma statement of income for the year 2015. When the registrant prepares that information, it changes the assumed acquisition date from January 1, 2014 to January 1, 2015. However, the assumed acquisition date for preparing the U.S. GAAP pro forma operating results remains at January 1, 2014. As a result, the pro forma amortization expense in the 2015 Article 11 pro forma statement of income will not agree with the 2015 pro forma amortization expense reflected in the footnotes to the registrant’s financial statements in its 2015 Form 10-K or its 2016 Form 10-K.

6 ASC 805-10-50-2.h.3.

7 FRM section 3230.1

Comment, “restrictions on pro forma adjustments prohibit a registrant from reflecting other significant changes it expects to result from the acquisition” and this may cause “some limitations as a predictor of the financial condition and results of operations of the combined entity following the acquisition.” We note that under the current requirements, while an adjustment must be factually supportable to be reflected on the face of pro forma financial statements, a registrant may discuss in footnotes to pro forma information the effects of actions to be taken by management and other expected effects of the transaction for which pro forma information is being presented.⁸ We suggest that the Commission evaluate whether the current approach achieves an appropriate balance by emphasizing consistency and reliability on the face of pro forma financial statements and allowing footnote disclosure to provide additional information to enhance usefulness.

If the Commission is inclined to take a different approach and change S-X Article 11 to enhance the usefulness of the information it elicits, then we suggest the Commission consider allowing pro forma adjustments to be presented in two separate columns. For example, the first column could include adjustments that have been traditionally accepted under the current model. A second column could be introduced to allow for other adjustments that have not been typically viewed as acceptable. We believe that this would preserve the consistency and reliability that currently exist and that doing so would help users distinguish the nature and effect of other adjustments.

Auditor Involvement

In the Request for Comment, the Commission has specifically asked about auditor involvement with pro forma financial information. While the Commission does not currently require auditors to perform procedures over pro forma financial information, there are a number of existing ways in which auditors currently have some involvement with pro forma financial information. When S-X Article 11 pro forma financial information is included in the same document as the financial statements on which an auditor has reported, as may be the case for an Item 2.01 Form 8-K or a registration statement, the auditor carries out its responsibilities as required by professional standards. Underwriters typically request the auditor’s involvement as part of the underwriters’ due diligence responsibilities. In the case of securities offerings, a registrant’s auditor is generally requested to provide negative assurance in a comfort letter on the application of pro forma adjustments to historical amounts in the compilation of pro forma financial information, and whether the pro forma financial information complies as to form in all material respects with the applicable accounting requirements of S-X Article 11. PCAOB AU sec. 634, *Letters for Underwriters and Certain Other Requesting Parties*, does not allow the auditor to provide this level of comfort unless the historical financial statements that serve as the basis for the pro forma financial information have been reviewed or audited. In other situations, auditors perform procedures and report findings in a comfort letter. While we do not sense a need for having greater auditor involvement with pro forma financial information, we believe investors and other users have the best insight to provide input on whether the market would demand greater auditor involvement than current practice.

Disposition Transactions

Significance threshold for providing pro forma financial information

S-X Rule 11-01(b)(2) requires that a registrant file pro forma financial information in a registration statement or an Item 2.01 Form 8-K for the disposition of assets or a business (as defined in S-X Rule 11-01(b)(2)) if the disposition is greater than 10% significant using the tests in S-X Rule 1-02(w). S-X Rule 11-01(b)(2) differentiates the percentage thresholds used to determine significance of an acquisition and a disposition of a business, requiring registrants to provide pro forma financial information for an acquisition using a 20% threshold versus a 10% threshold for a disposition. This disparity may result in confusion for preparers.

We recommend that the Commission consider raising the significance threshold for providing pro forma information related to dispositions to make it consistent with the significance threshold for providing pro forma financial information for acquisitions.

⁸ FRM section 3310.

Timing

Item 2.01 of Form 8-K requires that a registrant report a significant disposition of assets or a business within four business days of the transaction. The Form 8-K must also include the required pro forma financial information. We have observed instances of registrants intentionally delaying the closing date of disposition transactions in order to provide the time needed to meet the Form 8-K pro forma disclosure deadline. Changing business practice to meet such requirements may not be in the best interest of investors or the capital markets, so we suggest that the Commission consider whether the four-day period for reporting the pro forma effects of significant dispositions could be extended as it is for significant acquisitions.

IV. Financial information of equity method investees (S-X Rules 3-09 and 4-08(g))

Overall recommendations

As the Commission articulated in the Codification of Financial Reporting Releases (FRR) Section 213.03.b, the concepts of S-X Rules 3-09 and 4-08(g) are an extension of U.S. GAAP. The disclosures are designed to provide detailed information about a number that is presented net in the financial statements.

These financial statements may not be sufficiently informative to investors because of differences compared to the registrant's financial statements for matters such as reporting currency, fiscal years, accounting standards and basis of presentation. Moreover, companies can incur significant incremental costs in preparing these financial statements - even for periods when they are not significant - and having them audited.

Some of the challenges of complying with S-X Rule 3-09 include:

- Depending upon the ownership interest of the underlying investee and other factors such as membership on the board of directors and other positions within management, the registrant's/investor's level of influence over an investee can vary. Lower levels of ownership interest and other involvement with the investee can limit the ability of registrants to obtain investee financial statements to comply with the Commission's requirement.
- There are situations in which this information is being audited or audited in accordance with U.S. GAAS solely for the purpose of complying with S-X Rule 3-09.
- A company may not know if an investee is significant until close to or after year-end. Accordingly, the registrant may have difficulty obtaining the required financial statements and having them audited in a short period of time to file with the SEC or, alternatively, incur costs of obtaining and having the information audited when in fact it ultimately may not be required.

Additionally, the summarized information currently required by S-X Rule 4-08(g) that allows companies to combine unrelated entities may not provide an investor with sufficiently meaningful information when the registrant has different ownership percentages and/or investees with losses are combined with investees with income.⁹

We believe that the Commission could reduce the situations in which financial statements would be required by S-X Rule 3-09 and change the disclosure requirements of S-X Rule 4-08(g) in a way that would result in better information for investors and that would reduce overall compliance cost.

To do so, we suggest the SEC change S-X Rules 3-09 and 4-08(g) by increasing the threshold for significance to require separate financial statements under S-X Rule 3-09. While we think the appropriate threshold should be at the discretion of the Commission based upon input from investors and others, we believe the information provided by full separate financial statements should only be necessary when the investee is so significant that

⁹ For example, a company could have two equity affiliates - registrant owns 20% of Affiliate A which has \$200 of income and 50% of affiliate B which has a \$100 loss. This company would report income of \$100 in the summarized S-X Rule 4-08(g) information when it reports a loss of \$10 in the consolidated statement of income for equity affiliates.

financial information that would otherwise be provided by S-X Rule 4-08(g) does not provide sufficient information for investors to understand the consolidated results and financial condition of the registrant.

We also suggest the Commission amend S-X Rule 3-09 to only require financial statements for years in which the significance tests are met. While under current rules the financial statements for insignificant years can be unaudited, the financial statements still need to be prepared and provided in a manner consistent with Regulation S-X. Given the fact that the purpose of the financial statements of the investee is to supplement those of the registrant/investor, the Commission should consider whether they should be required for periods in which the investee is insignificant. Companies are currently incurring significant costs in preparing financial statements of investees that, by the Commission's definition, are not material.

As a result of the suggestion above to increase the threshold for determining significance under S-X Rule 3-09, financial statements would be required in fewer instances. However, more relevant information can be provided under S-X Rule 4-08(g) that will allow a reader to evaluate a registrant's various investee affiliates by modifying S-X Rule 4-08(g) as follows:

- Require summarized financial information for each investee that is individually significant to be presented separately. To better understand the information in the context of the registrant's financial statements, the information could be presented in a columnar format that reconciles the investees' net assets and net income to the consolidated financial statements.
- As under the existing rule, the information would be prepared using the same currency and the same accounting standards of the registrant.
- Eliminate the current requirement in S-X Rule 4-08(g) to present combined summarized financial information of investees when they exceed 10% significance in the aggregate and consider as an alternative whether qualitative or narrative disclosures would provide more useful information.

We also believe the Commission should reconsider the need to re-compute the significance of a registrant's investees if the registrant's financial statements are retrospectively revised because of a subsequent accounting change (other than a correction of an error), particularly under S-X Rule 3-09.

Foreign private issuers and foreign businesses

Foreign private issuers (FPIs) and foreign businesses have unique issues and challenges in preparing financial statements and having them audited for presentation under S-X Rule 3-09. To address these unique issues we suggest the following:

- FPIs are not required to comply with S-X Rule 4-08(g). Therefore, if the SEC proceeds with the suggestions above, it should consider amending Form 20-F to require conforming disclosure by FPIs or consider consolidating those disclosure requirements into S-X Rule 3-09, which does apply to FPIs.
- Consistent with our recommendations above related to S-X Rule 3-05, FPIs that prepare financial statements in accordance with IFRS should not be required to reconcile separate financial statements provided for purposes of S-X Rule 3-09 to U.S. GAAP if the investee is not a foreign business. Similarly, such FPIs should be permitted to provide S-X Rule 3-09 financial statements prepared under IFRS or reconciled to IFRS. The Commission should consider whether a U.S. GAAP reconciliation is meaningful when the registrant itself does not provide any U.S. GAAP information, and may actually be confusing to investors.
- Consistent with our recommendations under S-X Rule 3-05, we do not believe that the incremental benefit of having S-X Rule 3-09 financial statements audited using U.S. GAAS exceeds the incremental cost. We recommend that the Commission accept the audit of S-X Rule 3-09 financial statements of a foreign business using ISAs in circumstances where the audit report does not need to refer to the standards of the PCAOB. We believe this will result in a reduction of costs without a decrease in audit quality. This would not be applicable if the audit report is also included in the filing to comply with S-X Rule 2-05.

Interim reporting requirements

We recommend the Commission modify current interim disclosure requirements about investees to focus on significant changes similar to S-X Rule 10-01(a)(5). This will allow registrants to omit detailed interim financial disclosures about investees that have not changed significantly in amount or composition since the end of the most recently completed fiscal year. Such a change would be consistent with interim disclosure principles and may reduce compliance costs while still providing material information when appropriate.

Investment company considerations

We are aware that until the SEC staff's recent interpretations published in September 2013, BDCs prepared their financial statements and disclosures under the assumption that S-X Rules 3-09 and 4-08(g) do not apply to them. As articulated in FRR Section 213.03.b, the requirement to provide either separate financial statements or summarized financial information is related to the accounting concepts in APB Opinion 18, *The Equity Method of Accounting for Investments in Common Stock* (as codified in ASC 323), which does not apply to investment companies. Additionally, application of the significance tests for purposes of S-X Rules 3-09 and 4-08(g) has been functionally interpreted differently between the SEC's Divisions of Corporation Finance and Investment Management, resulting in complexity and confusion.

Nevertheless, we recognize there may be situations in which financial information for investees of investment companies may be material, such as when the significant investee itself is an investment company accounted for at fair value. If the Commission concludes that such information should be required, we recommend that the Commission consider, for purposes of the significance test, only investees that exist as of the reporting date and modify the measures applied to determine significance and the disclosure requirements for investment companies, particularly BDCs, as follows.¹⁰

Significance tests

The numerator of the income test, as mandated by S-X Rule 1-02(w), includes the registrant's equity in the investee's income from continuing operations. For an investment company, its "income" is measured by the net increase (or decrease) in its net assets from operations, and includes investment income earned as well as its realized and unrealized gains (or losses) on its investments.

Significance should be considered from an investor's perspective. For example, investors typically invest in BDCs for income distributions.¹¹ Accordingly, investment income is a key measure for users of a BDC's financial statements in evaluating a BDC's performance and its ability to pay dividends. Therefore, we recommend the Commission consider replacing the "income" in the existing income test with investment income¹² earned by a BDC from the investee (as the numerator) and the total consolidated investment income earned by such BDC (the denominator).¹³ Consistent with our recommendations on the significance tests earlier in the letter and the use of a two test approach, these recommendations more closely demonstrates the significance of the investment to the registrant and will tend to result in more consistent reporting from year to year.

10 We believe that these measures would also reasonably achieve the objective of Section 31 of the Investment Company Act of 1940 to avoid unnecessary recordkeeping by, and to minimize the compliance burden on investment companies to maintain book and records, while providing investors with information that is relevant to investment companies, including BDCs.

11 Investment companies, including BDCs, are regulated investment companies ("RICs") for tax purposes. To qualify for special tax treatment, a RIC must distribute at least 90% of its taxable income to its investors for the fiscal year. The major source for a RIC's taxable income generally comes from its investment income (or realized gains).

12 As presented in accordance with Rule 6.07.1 of Regulation S-X and with the guidance under bullet 1 of ASC 946-225-S99-1.

13 While most BDCs are investment income oriented vehicles, to the extent there are BDCs (or other investment companies) that continually earn, or expect to continue earning, a significant amount of "income" from gains, then these BDCs should be allowed to include such metric (gains and losses) as a basis for determining significance

Modification of the Financial Statements and Financial Information Provided under S-X Rules 3-09 and 4-08(g)

Similar to our observations above, we recommend that the SEC consider whether the inclusion of financial statements of investee portfolio companies is necessary under most circumstances for BDCs. Neither the operating results nor the financial condition of an investee portfolio company are directly included in or traceable to an investment company's financial statements. For example, a portfolio company's balance sheet information does not correlate to the fair value recorded on the investment company for such portfolio company, nor is the portfolio company's net income (or a share thereof) included on the investment company's statement of operations.

S-X Rule 12-14, *Investments in and advances to affiliates*, requires investment companies, including BDCs, to provide a schedule that includes specific information for each controlled portfolio company. Such information includes fair value at the reporting date, and interest income and dividend income during the reporting period, whereby the totals of these items agree to the balance sheet and to the income statement of the investment company. Therefore, in lieu of attaching the financial statements or providing summarized financial information for significant portfolio companies, we agree with the SEC's recent investment company reporting modernization proposal¹⁴ to expand the Schedule 12-14 on "controlled" investees to include net realized and unrealized gains on the investment for each significant portfolio company. These disclosures would be useful to users of the investment company's financial statements in assessing the contributions of each portfolio company to the investment company's operating performance and financial condition.

Alternatively, if the Commission does not agree with the suggestion above and believes S-X Rule 3-09 and S-X Rule 4-08(g) financial information is needed, we recommend that certain summarized information (which may include a schedule of investments for an investment company investee) for each significant investee (with no aggregation) be provided in lieu of separate financial statements consistent with our recommendations for operating companies discussed above.

V. Financial information of guarantors or issuers of guaranteed securities registered or being registered (S-X Rule 3-10)

In our experience, compliance with the reporting requirements of S-X Rule 3-10 is difficult and time-consuming for registrants. We have seen extensive negotiation involving management, professional advisors and lenders to structure debt offerings and related subsidiary and parent guarantees to meet or avoid S-X Rule 3-10 requirements in Securities Act and Exchange Act filings.

While the prescribed alternative disclosure (i.e., condensed consolidating financial information) available under certain circumstances provides relief from filing numerous sets of financial statements under the Securities Act and Exchange Act, the preparation of condensed consolidating financial information presents its own challenges. Registrants do not always maintain books and records to capture the required financial information for each individual issuer, co-obligor or guarantor. In particular, investment by a parent entity in lower level subsidiaries, intercompany accounts and cash flow information are not typically available, necessitating detailed and expensive analysis. The resulting alternative disclosure for comparative periods on both an annual and quarterly basis is cumbersome, sometimes filling many pages of a filing. The effect is amplified when a single registrant has numerous public debt issuances with differing guarantee structures.

We believe the current reporting could be streamlined by allowing a registrant to present financial information (e.g., summarized or condensed) in its annual financial statement footnotes or in a schedule to the filing that distinguishes between all guarantors and issuers as a group and non-guarantors, if guarantees are full and unconditional. We also believe it reasonable to consider limiting quarterly financial information for subsidiary issuers and guarantors using the same "updating" concept available in S-X Rule 10-01(a)(5). We believe that the Commission is in the best position to determine the appropriate detail and timing of financial information

¹⁴ Securities Act Release 33-9776, page 136.

related to public debt guarantees after it considers the recommendations of preparers and users of financial statements.

Some foreign jurisdictions legally require some portion of ownership interest by a third party which can result in a guarantor subsidiary in such a jurisdiction not meeting the definition of 100% owned as referenced in S-X Rule 3-10(h)(1). Registrants that want to avail themselves of providing the alternative disclosure in lieu of separate financial statements of the guarantor are required to pre-clear their fact patterns with the SEC staff when 100% ownership is not met. The Commission should consider amending the definition of 100% owned to include scenarios where foreign jurisdictions legally require a minor portion of ownership interests to be held by a third party and only the minimum amount legally required is held by the third party. This would enable efficiency, as there would be certainty in the application of the rules, without having to seek SEC staff approval.

Financial presentation could further be simplified by:

- Eliminating the distinction between a parent with no independent assets or operations and a parent that does have independent assets or operations for purposes of allowing narrative disclosure when all subsidiaries guarantee.
- Eliminating the practice of requiring a registrant to continue to provide the alternative disclosure as long as its debt is outstanding (and guaranteed), regardless of whether it is deregistered.
- If financial information is required to satisfy the objective of S-X Rule 3-10(g) for newly acquired guarantor subsidiaries, allowing registrants to use the same significance testing metrics discussed above for acquired businesses (by comparison of the acquired guarantor subsidiaries to the guarantors and issuers combined) instead of the current test involving the principal amount of the securities being registered. A non-public newly acquired guarantor or issuer subsidiary's audited financial statements should not be required to comply with public company form and content, nor should it be required to meet PCAOB audit requirements. Finally, the Commission should further consider whether the level of detail for such information could be presented in a manner consistent with whatever is accepted for other guarantors.

VI. Financial statements of affiliates that collateralize registered securities (Rule S-X 3-16)

S-X Rule 3-16 requires separate financial statements of affiliates that collateralize an issuance of registered debt if their securities constitute a substantial portion of collateral.¹⁵ To assess whether audited annual financial statements of such affiliates are necessary, registrants are required to perform the “substantial portion of collateral” test on the offering date and as of the end of each fiscal year for which a Form 10-K or Form 20-F is required.

In lieu of full financial statements, we recommend that registrants be permitted to provide certain summarized financial information as determined appropriate for affiliates whose securities provide substantial collateral for an issue of registered debt. For example, S-X Rule 4-08(b) could be expanded to include this disclosure requirement.¹⁶ We believe that summarized financial information in the registrant's audited financial statements would give holders of the collateralized securities a sufficient understanding of the financial condition of the affiliate(s) and may encourage a greater use of collateralization structures to provide additional support for investors.

We also recommend that the Commission revise the substantial portion of collateral test for purposes of the Form 10-K annual reassessment. We believe that the denominator in the test should be the amount of collateralized securities originally issued, not the amount outstanding as of the reassessment date. That is, we do not believe an affiliate should meet the substantial portion of collateral test just because a portion of the collateralized securities has been repurchased or repaid.

¹⁵ Securities constitute a substantial portion of collateral under S-X Rule 3-16 if the aggregate principal amount, par value, book value or market value of the securities pledged as collateral, whichever is the greatest, equals 20% or more of the principal amount of the collateralized securities.

¹⁶ Foreign private issuers are not required to comply with S-X Rule 4-08(b). Therefore, if the SEC expands this rule to include financial information for affiliates that substantially collateralize the issuance, it should consider similar requirements for foreign private issuers.

VII. Consideration of XBRL tagging in other entity financial statements

The SEC's final rule, *Interactive Data to Improve Financial Reporting*,¹⁷ stated that the intent of XBRL tagging was "not only to make financial information easier for investors to analyze, but also to assist in automating regulatory filings and business information processing...[and] the potential to increase the speed, accuracy and usability of financial disclosure, and eventually reduce costs."

Requiring companies to tag separate financial statements of other entities would result in significant costs, particularly when those entities are private companies that do not have processes or experience with XBRL tagging and the registrant may not have sufficient knowledge of the financial reporting of the other entities to adequately tag the financial statements. We also question the utility of tagging financial statements that are not expected to be filed on a recurring basis. Therefore, S-X Rule 3-05 financial statements should continue to be excluded from the scope of XBRL tagging. We believe further study is necessary to determine whether the benefits of tagging financial statements of equity method investees would outweigh the costs.

We thank the SEC for providing the Center for Audit Quality with the opportunity to express its views on the questions raised in the Request for Comment. As the Staff and Commission gather feedback from preparers, users and other interested parties, we would be pleased to discuss our comments or answer any questions that the Staff or Commissioners may have regarding the views expressed in this letter.

Sincerely,



Cynthia M. Fornelli
Executive Director
Center for Audit Quality

cc:

SEC

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¹⁷ Release Nos. 33-9002; 34-59324; 39-2461; IC-28609, 10 February 2009