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SEC's Financial Disclosure Requirements For Sub-Entities Of Registered Companies

The following is written by Laura Anthony, Esq., a going public attorney focused on OTC listing requirements, direct public offerings, going public transactions, reverse mergers, Form 10 and Form S-1 registration statements, SEC compliance and OTC Market reporting requirements.

As required by the JOBS Act, in 2013 the SEC launched its Disclosure Effectiveness Initiative and has been examining disclosure requirements under Regulation S-K and Regulation S-X and methods to improve such requirements. In September 2015, the SEC issued a request for comment related to the Regulation S-X financial disclosure obligations for certain entities other than the reporting entity. In particular, the SEC is seeking comments on the current financial disclosure requirements for acquired businesses, subsidiaries not consolidated, 50% or less owned entities, issuers of guaranteed securities, and affiliates whose securities collateralize the reporting company's securities.

It is important to note that the SEC release relates to general financial statement and reporting requirements, and not the modified reporting requirements for smaller reporting companies or emerging growth companies. In particular, Article 8 of Regulation S-X applies to smaller reporting companies and Article 3 to those that do not qualify for the reduced Article 8 requirements. The SEC discussion and request for comment specifically addresses certain Article 3 rules.

As my clients are, for the most part, either smaller reporting companies or emerging growth companies, I have provided information related to those entities where applicable. In the request for comment, the SEC does ask for input and comments on the correlating Article 8 rules where applicable.

Specific rules being addressed

The SEC request for comment is specifically related to the following rules and their related requirements:

- Rule 3-05, Financial Statements of Businesses Acquired or to be Acquired;
- Rule 3-09, Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons;
- Rule 3-10, Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered; and
- Rule 3-16, Financial Statements of Affiliates Whose Securities Collateralize an Issue Registered or Being Registered.

The comments sought and the SEC review are centered on how these requirements assist and inform investors and potential investors in making investment and voting decisions on the one hand, and the challenges and issues of the reporting company in preparing and providing the information on the other hand. Moreover, as required by the Exchange Act in all SEC rulemaking, the SEC must consider how any changes will promote efficiency, competition and capital formation.

Rule 3-05 of Regulation S-X – Financial Statements of Businesses Acquired or to be Acquired

Summary of current rule

Rule 3-05 of Regulation S-X requires a reporting company to provide separate audited annual and reviewed stub period financial statements for any business that is being acquired if that business is significant to the company. A “business” can be acquired whether the transaction is fashioned as an asset or stock purchase. The question of whether it is an acquired “business” revolves around whether the revenue-producing activity of the target will remain generally the same after the acquisition. Accordingly, the purchase of revenue producing assets will likely be treated as the purchase of a business.

In determining whether an acquired business is significant, a company must consider the investment, asset and income tests set out in Rule 1-02 of Regulation S-X. The investment test considers the value of the purchase price relative to the value of the total assets of the company prior to the purchase. The asset test considers the total value of the assets of the company pre and post purchase. The income test considers the change in income of the company as a result of the purchase.

Rule 3-05 requires increased disclosure as the size of the acquisition, relative to the size of the reporting acquiring company, increases based on the investment, asset and income test results. If none of the test results exceed 20%, there is no separate financial statement reporting requirement as to the target company. If one of the tests exceeds 20% but none exceed 40%, Rule 3-05 requires separate target financial statements for the most recent fiscal year and any interim stub periods. If any Rule 3-05 text exceeds 40% but none exceed 50%, Rule 3-05 requires separate target financial statements for the most recent two fiscal year and any interim stub periods. When at least one Rule 3-05 test exceeds 50%, a third fiscal year of financial statements are required, except that smaller reporting and emerging growth companies are never required to add that third year.

Rule 8-04 is the sister rule to 3-05 for smaller reporting companies. Rule 8-04 is substantially similar to Rule 3-05 with the same investment, asset and income tests and same 20%, 40% and 50% thresholds. However, Rule 8-04 has some pared-down requirements, including, for example, that a third year of audited financial statements is never required where the registrant is a smaller reporting company.

Both Rule 3-05 and 8-04 require pro forma financial statements. Pro forma financial statements are the most recent balance sheet and most recent annual and interim income statements, adjusted to show what such financial statements would look like if the acquisition had occurred at that earlier time.

An 8-K must be filed within 4 days of a business acquisition, disclosing the transaction. The Rule 3-05 or 8-04 financial statements must be filed within 75 days of the closing of the transaction via an amendment to the initial closing 8-K. Where the acquiring public reporting company is a shell company, the required Rule 8-04 financial statements must be included in that first initial 8-K filed within 4 days of the transaction closing (commonly referred to as a Super 8-K). By definition, a shell company would always be either an emerging growth or smaller reporting company and accordingly, the more extensive Rule 3-05 financial reporting requirements would not apply in that case.

The Rule 3-05 or Rule 8-04 financial statements will also be required in a pre-closing registration statement filed to register the transaction shares or certain other pre-closing registration statements where the investment, asset or income tests exceed 50%. Likewise, the Rule 3-05 or Rule 8-04 financial statements are required to be included in pre-closing proxy or information statements filed under Section 14 of the Exchange Act seeking either shareholder approval of the transaction itself or corporate actions in advance of a transaction (such as a reverse split or name change). See my short blog HERE discussing pre-merger Schedule 14C financial statement requirements.

In what could be a difficult and expensive process for companies engaged in an acquisition growth model, if the aggregate impact of individually insignificant business acquisitions exceeds 50% of the investment, asset or income tests, Rule 3-05 or Rule 8-04 financial statements and pro forma financial statements must be included for at least the substantial majority of the individual acquired businesses.

Reason for the rules and request for comment

Clearly financial disclosure regarding acquired businesses is important for an investor to understand the impact of transactions. An acquisition will change a company's financial condition, results of operation, liquidity and future prospects. However, the SEC admits that the type of information currently required may have limitations vis-à-vis the intended purpose. Many commentators have questioned the need and utility of historical financial information on the acquired business. Historical financial statements do not reflect the new accounting basis resulting from the acquisition, changes in management, changes in business plan, the efficiencies of scale of the combined entities (such as workforce reductions and facility closings), etc.

Related to the financial statement requirements, the SEC specifically requested comments associated with (i) how investors use the financial information; (ii) what changes would make the information more useful to investors and what challenges are there to providing this information; (iii) what challenges companies have in providing the currently required financial information and how these could be addressed; (iv) whether the current requirements include information that is not useful; (v) how pro forma requirements could be changed to make them more useful; (vi) whether the 75-day rule should be shortened; and (vii) whether the pre-closing requirements for registration statements and Section 14 (Schedule 14C or 14A) filings should be modified.

Related to the investment, asset and income tests, the SEC specifically requested comments on (i) whether the current significance tests are the appropriate measure to determine the nature, timing and extent of financial statement disclosure requirements; (ii) what changes or alternatives the SEC should consider; (iii) whether the current test thresholds should be modified; (iv) whether additional or different tests should be implemented (such as purchase price compared to market cap); and (v) whether companies should be given more judgment in determining what is significant.

The SEC has also asked for comment on the application of changes to Rule 8-04 for smaller reporting companies and application of the rules to different issuers such as investment companies and foreign private issuers.

Rule 3-09 of Regulation S-X – Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons

Summary of current rule

Rule 3-09 does not apply to smaller reporting companies or emerging growth companies at all and, as such, I am only providing a very brief review. Rule 3-09 requires that certain separate financial statements be provided for subsidiaries and persons even if the reporting company owns less than 50% if the investment is significant. Significance is determined using modifications of the investment and income tests. If neither of the tests exceed 20%, no Rule 3-09 financial statements are required, but if either exceeds 20%, all financial statements are required and such statements must be audited for each year that a test exceeds the 20% threshold.

Separately Rule 4-08 requires summarized financial information in the notes to financial statements if a Rule 3-09 test exceeds 10%. This summarized financial information is not required if the full separate financial statements are otherwise provided.

Reason for the rules and request for comment

Even investments in businesses that are not controlling (over 50%) impact financial condition, results of operation, liquidity and future prospects – hence, the Rule 3-09 requirements. However, as with Rule 3-05, the SEC recognizes the limited utility of the current requirements. One of the biggest concerns is the inability to reconcile separate financial statements for these investment entities, with the value of such investment on the financial statement on the registrant's balance sheet. Moreover, the aggregation of investments in the summary presentations further dilutes the ability to discern particular value for any one individual entity's separate financial statements.

The SEC is requesting comment on (i) how investors use Rule 3-09 financial information; (ii) what changes could be made to make the information more useful to investors; (iii) what challenges companies face in obtaining and preparing this financial information; (iv) how those challenges can be addressed or improved; and (v) whether there are parts of the current requirements that are not useful.

Related to the investment and income tests, the SEC specifically requested comments on (i) whether the current significance tests are the appropriate measure to determine the nature, timing and extent of financial statement disclosure requirements; (ii) whether the Rule 3-09 tests should be modified to correlate more closely with other financial statement requirements in Regulation S-X (such as Rule 10-01); (iii) what changes or alternatives the SEC should consider; (iv) whether the current test thresholds should be modified; (v) whether additional or different tests should be implemented (such as purchase price compared to market cap); and (vi) whether companies should be given more judgment in determining what is significant.

The SEC has also requested comment on whether Rule 3-09 should be expanded to include smaller reporting companies and emerging growth companies. My view on this is a definite "no." The SEC has asked comment on whether Rule 3-09 should be modified for business development companies and, if so, in what way. My view on this is "yes," but an in-depth discussion on business development companies is beyond the scope of this blog.

Rule 3-10 of Regulation S-X – Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered

Summary of current rule

A guarantor of a registered security is considered an issuer because the guarantee itself is considered a separate security. Accordingly, both issuers of registered securities, and the guarantor of those registered securities, must file their own audited annual and reviewed stub period financial statements under Rule 3-10 of Regulation S-X. Rule 3-10 provides certain exemptions, including (i) where a parent company offers securities guaranteed by one or more of its subsidiaries; or (ii) where a subsidiary offers securities guaranteed by another subsidiary.

Also, if the subsidiary issuer and guarantor satisfy certain conditions, the parent company can provide disclosures in its regular annual and interim consolidated financial statements for each subsidiary and guarantor (called "Alternative Disclosure"). Without getting into the minutiae of how to qualify for Alternative Disclosure, generally to qualify the subsidiary issuer/guarantor must be 100% owned by the parent and the guarantees must be full and unconditional.

In simple terms, usually a parent company merely consolidates the financial statements of its subsidiaries and no separate financial statement information is provided for individual operating subs. Where a sub or parent becomes a separate issuer or guarantor, separate financial information must be filed for those subsidiaries. Where qualified, Rule 3-10 allows for a tabular footnote disclosure of this information, as opposed to full-blown audits and reviews of each affected subsidiary. The footnote tables are referred to as Alternative Disclosure.

The requirements under Alternative Disclosure include tables in the footnotes for each category of parent and subsidiary and guarantor. The table must include all major captions on the balance sheet, income statement and cash flow statement. The columns must show (i) a parent's investment in all consolidated subsidiaries based on its proportionate share of the net assets; and (ii) a subsidiary issuer/guarantor's investment in other consolidated subsidiaries using the equity accounting method.

To avoid a disclosure gap for recently acquired subsidiaries, a Securities Act registration statement of a parent must include one year of audited pre-acquisition financial statements for those subsidiaries in its registration statement if the subsidiary is significant and such financial information is not being otherwise included. A subsidiary is significant if its net book value or purchase price, whichever is greater, is 20% or more of the principal amount of the securities being registered. The parent company must continue to provide the Alternative Disclosure for as long as the guaranteed securities are outstanding.

Reason for the rules and request for comment

The rule is designed to provide investors with information to evaluate the likelihood of payment by the issuer and guarantors. The format and content of the Alternative Disclosure is unique and not found elsewhere in SEC rules or accounting standards.

The SEC has requested comment on (i) how investors use Rule 3-10 financial information; (ii) what changes could be made to make the information more useful to investors; (iii) what challenges companies face in obtaining and preparing this financial information; (iv) how those challenges can be addressed or improved; and (v) whether there are parts of the current requirements that are not useful.

In addition, the SEC has requested comments on the conditions that must be satisfied to qualify for Alternative Disclosure and the time periods for providing such disclosure.

Rule 3-16 of Regulation S-X – Financial Statements of Affiliates Whose Securities Collateralize an Issue Registered or Being Registered

Summary of current rule

Rule 3-16 requires a company to provide separate financial statements for each affiliate whose securities act as a substantial part of collateral for securities being registered. The financial statements must be provided as if that affiliate were a separate registrant. The affiliate's portion of the collateral is determined by comparing (i) the highest amount among the aggregate principal amount, par value, book value or market value of the affiliate's securities to (ii) the principal amount of the securities registered or to be registered. If the test equals or exceeds 20% for any fiscal year presented by the registrant, Rule 3-16 financial statements are required. Similarly, but separately, Rule 4-08 requires financial statement footnote disclosure of amounts of assets mortgaged, pledged or otherwise subject to a lien.

Reason for the rules and request for comment

The disclosures are meant to provide information on the ability of an affiliate to meet an obligation where the registrant defaults. However, many believe that the financial disclosure is confusing and not very useful to meet its intended purpose.

The SEC has requested comment on (i) whether the Rule 3-16 requirements influence the structure of collateral arrangements and, if so, what the consequences are to investors and registrants; (ii) how investors use Rule 3-16 financial information; (iii) what changes could be made to make the information more useful to investors; (iv) what challenges companies face in obtaining and preparing this financial information; (v) how those challenges can be addressed or improved; and (vi) whether there are parts of the current requirements that are not useful.

Additional information and further reading

The SEC has received many comment letters in response to its request and, on January 13, 2016, met with representatives of Deloitte & Touche on the subject. This blog summarizes the current rules and the SEC request for comment but does not include a discussion of the comment letters submitted to the SEC. Although many of the comment letters themselves contain useful and thought-provoking information, they are numerous and lengthy and such discussions may or may not ultimately influence the actual rules we practitioners work with. I will, of course, blog about future rules and rule amendments resulting from these discussions. For those interested in reading the comment letters, they can be found HERE.

I have written several times on the SEC initiative and the subject of improving the disclosure requirements for reporting companies. Several of the provisions in the recent FAST Act were related to these initiatives. In particular, The FAST Act adopted many of the provisions of a bill titled the Disclosure Modernization and Simplification Act, including rules to: (i) allow issuers to include a summary page to Form 10-K (Section 72001); and (ii) scale or eliminate duplicative, antiquated or unnecessary requirements for EGCs, accelerated filers, smaller reporting companies and other smaller issuers in Regulation S-K (Section 72002). In addition, the SEC is required to conduct yet another study on all Regulation S-K disclosure requirements to determine how best to amend and modernize the rules to reduce costs and burdens while still providing all material information (Section 72003). See my blog on the FAST Act and these provisions HERE.

In September 2015, the SEC Advisory Committee on Small and Emerging Companies (the “Advisory Committee”) met and finalized its recommendation to the SEC regarding changes to the disclosure requirements for smaller publicly traded companies. My blog on these recommendations can be read HERE.

Prior to that, in March 2015, the American Bar Association submitted its second comment letter to the SEC making recommendations for changes to Regulation S-K. For a review of these recommendations, see my blog HERE.

The Author

Attorney Laura Anthony
Founding Partner
Legal & Compliance, LLC
Corporate, Securities and Going Public Attorneys
LAnthony@LegalAndCompliance.com

Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, the securities law network.

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