

# Technical Line

## Tips for complying with the SEC reporting requirements for equity method investees

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### What you need to know

- ▶ In preparing to file annual reports with the SEC, registrants should make sure they comply with Regulation S-X Rule 3-09 and Rule 4-08(g) reporting requirements for equity method investees.
- ▶ Registrants need to include audited financial statements or summarized financial information for equity method investees that meet certain thresholds of “significance.”
- ▶ Failure to comply with the rules could make a registrant’s periodic report deficient and result in a suspension of the registrant’s eligibility to use shelf registration.

### Overview

When preparing periodic reports (e.g., Forms 10-K, 10-Q) and registration statements (e.g., Form S-1), registrants need to comply with the reporting requirements for significant equity method investments under Regulation S-X Rule 3-09 and Rule 4-08(g).

Based on our experience, some companies are surprised by these requirements and have to scramble to evaluate whether they comply, particularly when there have been significant changes in the financial results of the registrant or its investees. Some of these companies request that the Securities and Exchange Commission (SEC) staff waive the requirement to file S-X Rule 3-09 financial statements.

Failure to comply with these rules could make the periodic report deficient, which could lead to the registrant becoming ineligible to use shelf registration, among other consequences.

This publication discusses key considerations relating to how to calculate significance, reporting requirements if an investee meets certain thresholds of significance, the appropriate accounting standards in financial statements or financial information required under the rules, and associated interim disclosure requirements.

## Key considerations

### **Determining whether an equity method investee is significant**

A registrant determines how significant an investee is by comparing (1) its share of the investee's pretax income from continuing operations to its own income, (2) its investment in the investee to its total assets and (3) its proportionate share of the investee's total assets to its total assets. These calculations, described in Regulation S-X Rule 1-02(w), are referred to as the significance tests.

Separate audited financial statements are required if either of the first two calculations is 20% or more. Summarized financial information is required if any of the three calculations for an investee individually or combined with other investees exceed 10%.

A registrant must perform the calculations for each year of financial statements it will include in a filing. For example, if the filing includes financial statements for 2014, 2015 and 2016, the significance tests must be performed separately for each of those three years. If prior-period financial statements have been retrospectively revised in the current Form 10-K, the SEC staff requires that registrants calculate significance using the revised numbers if the company reported a discontinued operation but not if it reported a change in accounting principle.

### ***Reporting requirements***

If the calculation in either the income or investment significance test exceeds 20% for any of the years presented in the filing, the registrant is required to file financial statements for the investee for each of the years presented.<sup>1</sup> As a result, companies may be required to provide financial statements for an investee in the current year, even if the investee does not meet the significance threshold in that year. The investee's separate financial statements only need to be audited for the years when significance, based on the income or investment test, exceeds 20%.

If, based on any of the tests, an investee's significance exceeds 10% either individually or for any combination of investees, the notes to the annual financial statements must include summarized financial information, which may be aggregated, for all years presented. Smaller reporting companies (SRCs) must do this if any of the tests exceed 20% on an individual or combined basis.

### ***Acquiring or disposing of equity method investees***

Separate financial statements of significant investees are required only for the period of the registrant's ownership (or for the period in which the investment is accounted for under the equity method). That might be part of a year in which a registrant acquires or disposes of a significant investee (or commences or ceases reporting under the equity method).

When a registrant determines that audited financial statements for part of the year are required but cannot be obtained without undue difficulty or cost, the SEC staff has in some cases granted written requests that the registrant be allowed to provide the investee's financial statements for the entire year, sometimes with additional disclosures.

### ***Filing dates for S-X 3-09 financial statements***

If the investee is a US company, financial statements required by S-X 3-09 must be filed within the following number of days after the investee's fiscal year end, unless that date precedes the registrant's 10-K filing date, in which case those financial statements would be included in the original filing rather than an amendment:

- ▶ 60 days if the investee is a large accelerated filer
- ▶ 75 days if the investee is an accelerated filer
- ▶ 90 days for all other investees

The SEC staff permits registrants that file S-X 3-09 financial statements to omit S-X 4-08(g) summarized financial information disclosures for those investees. However, if the S-X 3-09 financial statements are not filed at the same time as the Form 10-K, the registrant must include S-X 4-08(g) summarized financial information in the Form 10-K, and the SEC staff doesn't provide extensions.

If the investee meets the definition of a foreign business,<sup>2</sup> S-X 3-09 financial statements must be filed within six months of the investee's year end but not earlier than the due date of the registrant's annual report. It is important that registrants understand that financial statements of investees that are foreign businesses must be audited in accordance with US auditing standards even if they qualify to be presented under IFRS as issued by the International Accounting Standards Board.

### ***Applying the appropriate accounting standards***

If a registrant is required to include an investee's financial statements or summarized financial information in its SEC filings under Regulation S-X Rule 3-09 or Rule 4-08(g), the investee is considered a public business entity (PBE) under US GAAP.<sup>3</sup>

Therefore, the financial statements and summarized financial information for these investees should be prepared using the PBE effective dates for new accounting standards, and private company accounting alternatives provided under US GAAP cannot be used. However, a private company that is considered a PBE for the purpose of Rule 3-09 or Rule 4-08(g) would not have to follow US GAAP applicable only to public companies such as earnings per share, segment information and certain pension disclosures.

Individually insignificant investees may meet the definition of a PBE for purposes of the disclosure if their significance, when combined with the investor's other equity method investments, exceeds 10%.

### **Calculating the significance tests**

#### ***Determining the numerator***

The numerator for the income significance test depicts the registrant's proportionate share of the investee's pretax income from continuing operations as reflected in its investee's separate financial statements for the period in which the registrant recognizes income or loss from the investee under the equity method of accounting. Therefore, the numerator is not necessarily the amount of equity income or loss recorded for the investment in the registrant's financial statements.

Registrants may need to include audited financial statements or summarized financial information for investees in their Form 10-K.

Significance should be based on the registrant's overall proportionate ownership of the investee rather than the direct interest of its consolidated subsidiaries. For example, if a registrant consolidates an 80% owned subsidiary, which has a 50% ownership stake in an equity method investee, the numerator would be 40% (i.e., 80% of the 50%) of the investee's pretax income as reflected in its separate financial statements.

#### ***Unusual trends in earnings***

S-X 1-02(w) allows a registrant to use the average of its past five years of earnings as the denominator in the income significance test if its earnings or loss in the most recent year is at least 10% less than the average of the last five fiscal years (the investee's average income cannot be used as the numerator in the test). Losses are reflected as zeros rather than negative numbers, meaning a registrant with losses in all periods would not average as it would yield a result of zero.

#### **Example: Five-year averaging calculation for income test under S-X 1-02(w)**

Income (loss) from continuing operations	Registrant	Investee (proportionate share)
20Y2	\$ 300	\$ 130
20Y1	\$ (300)	\$ 180
20Y0	\$ (400)	\$ (20)
20X9	\$ 1,850	n/a
20X8	\$ 1,350	n/a

**Computation:** Registrant's five-year average income (loss) from continuing operations before income taxes and the cumulative effect of a change in accounting principle exclusive of amounts attributable to noncontrolling interests:  $\$300 + \$0 + \$0 + \$1,850 + \$1,350 = \$3,500/5 = \$700$

**Conclusion:** Registrant should use the five-year average of \$700 as the denominator in computing significance of Investee for the income test because 20Y2 income is at least 10% less than the average (in this case, 20Y2 income of \$300 is 57% less than the average of \$700). For 20Y2, separate audited financial statements of Investee are not required because Investee income of \$130 is only 18.6% of the Registrant's five-year average income of \$700. However, summarized financial information would be required.

Registrants cannot adjust the numerator or denominator (e.g., for nonrecurring losses or gains such as impairment charges or restructuring charges). A registrant that believes the tests yield anomalous results for this or any other reason (e.g., a break-even year) can submit a formal waiver request to the SEC staff.

#### **Interim disclosure requirements**

Regulation S-X Article 10, *Interim Financial Statements* (and Article 8 for SRCs), requires summarized income statement information in Form 10-Q for equity method investees for which separate or combined audited financial statements would otherwise be required under Rule 3-09. That is, summarized income statement information would be required for those equity method investees that meet either the investment test or the income test at the 20% level applied to each balance sheet and year-to-date income statement period presented. The disclosure for each significant investee (which may be aggregated) must include: revenues; gross profit; income from continuing operations; and net income, for the current and prior year-to-date periods included in the quarterly report. The disclosure needs to include only investees that are individually significant in the interim periods presented.

**Endnotes:**

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- <sup>1</sup> Regulation S-X Rule 3-09 does not require SRCs to provide separate audited financial statements of equity investees, but the annual financial statements of SRCs must consider the disclosure requirements of Accounting Standards Codification 323-10-50-3c. The interim financial statements of SRCs must provide summarized financial data for significant (>20%) equity investees under Regulation S-X 8-03.
- <sup>2</sup> Regulation S-X 1-02(l) defines a foreign business as: "A business that is majority owned by persons who are not citizens or residents of the United States and is not organized under the laws of the United States or any state thereof, and either: (1) More than 50 percent of its assets are located outside the United States; or (2) The majority of its executive officers and directors are not United States citizens or residents."
- <sup>3</sup> The Master Glossary in the Accounting Standards Codification defines a PBE as an entity that "is required to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in the filing)," among other things.

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