An Overview of the Financial Statement Requirements for U.S. Securities Offerings
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August 2003

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“The most frequently asked question at all-hands meetings is ‘What financial statements will be required?’ This Practice Guide provides a user-friendly answer to that seemingly simple question.”

I. Summary

Public securities offerings under the Securities Act of 1933 generally require the filing of a registration statement with the SEC and the distribution of a prospectus in connection with the offering. The registration statement and prospectus must contain a basic package of financial statements and other financial information to illustrate the financial condition and results of operations of the issuer. The 1933 Act and the related rules and regulations detail the disclosure requirements through the use of “forms” (Forms S-1, S-2 and S-3) which specify certain items that must be disclosed under Regulation S-K (where all textual disclosure requirements can be found) and under Regulation S-X (which specifies the financial statements required to be filed). Although the requirements of the 1933 Act are not strictly applicable to private offerings under Rule 144A, it has become standard practice to follow these rules as if they were applicable to Rule 144A offerings, with only limited exceptions, as discussed below.

The most frequently asked question at all-hands meetings is “What financial statements will be required?” This Practice Guide provides a user-friendly answer to that seemingly simple question. We will first discuss the requirements applicable to public offerings by domestic companies and then address the customs in the Rule 144A market. We also briefly summarize special rules applicable to “foreign private issuers” (a term that covers most non-U.S. issuers other than foreign governments). For a detailed discussion of those rules, see our companion practice guide “An Overview of the Financial Statement Requirements for U.S. Securities Offerings, U.S. Listings and U.S. Annual Reports by Non-U.S. Issuers.”

In this Practice Guide we have assumed for ease of illustration that the issuer’s fiscal year is a calendar year. If your issuer has a different fiscal year end, the dates provided below will need to be adjusted accordingly. We also note that experienced issuers may incorporate by reference into their offering documents much of the financial information discussed here. Issuers who are eligible for incorporation by reference will want to consult their underwriters before electing to incorporate all required financial information. For marketing purposes it is often desirable to provide the financial information directly in the printed offering document.

II. Basic Financial Information Requirements

The basic issuer financial information that must be contained in an offering document is the same for all types of public offerings. These requirements are summarized in the table below. The timing of the “staleness” of particular financial statements is addressed below under the heading “Age of Financial Statements.”

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<table>
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<th>Annual Financial Statements Required</th>
<th>Interim Financial Statements Required</th>
<th>Other Financial Information Required</th>
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<tbody>
<tr>
<td>§ Audited balance sheets as of the end of the two most recent fiscal years.</td>
<td>§ Unaudited balance sheet as of the end of the most recently ended fiscal quarter.</td>
<td>§ Selected income statement and balance sheet data for each of the last five fiscal years and any subsequent interim period.²</td>
</tr>
<tr>
<td>§ Audited income statements, cash flow statements, and statements of stockholders’ equity for each of the three most recent fiscal years.³</td>
<td>§ Unaudited income statements, cash flow statements, and statements of stockholders’ equity for:</td>
<td>§ Supplementary income statement data for each full quarter within the two most recent fiscal years and any subsequent interim period.⁴</td>
</tr>
<tr>
<td></td>
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<td>§ For debt or preferred equity securities, coverage ratios for each of the last five fiscal years and for any interim periods presented.⁵</td>
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<td>§ Pro forma financial information (where required by S-X 11-01):⁶</td>
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</table>

Many of these financial statement and other financial information requirements can be satisfied through incorporation by reference by issuers eligible to use Form S-2 or Form S-3.⁷

In addition to the formal requirements of Regulations S-K and S-X, it is customary to include certain other information in the offering document that may be material or convenient for investors in considering the financial condition of the issuer:

- **Summary Financial Data**: A page of summary financial data is routinely included in the “summary box” in the offering document. Although there are no specific line item requirements for this key marketing page, it usually contains income statement, balance sheet, and other financial data for the last three to five fiscal years and the most recent interim period (as well as the comparable interim period in the prior year) comparable to that required on the “Selected Financial Data” page that appears later in the disclosure document. Key operational metrics are also included in the summary under a heading such as “Other Financial Data.” These metrics will vary with the type of issuer (e.g., comparable store sales for a retailer, capital expenditures for a manufacturer, subscriber numbers for a cable television company, etc.).⁸
• **Recent Results:** There is no specific rule requiring a “Recent Developments” section in the offering document and case law does not clearly require issuers to provide information about a quarter in progress or that has just recently ended but for which no complete financial statements are available. However, it may be desirable from a marketing perspective to include a summary of recent financial results in the “summary box.” If the recent results are negative, it may be advisable to include recent results disclosure to avoid any negative surprises for investors when the full quarterly numbers become available. For example, the issuer may be aware that its sales are trending down in the current quarter, or that significant charges will be taken in connection with an acquisition after it closes. Even if Wall Street analysts may be anticipating such an event, it is preferable to disclose this information in the offering document itself to avoid a risk of future litigation. At the “road show” meetings, prospective investors will be asking about the results for a quarter just or almost completed and presenting information in the offering document will facilitate a discussion of these results. 

• **Recent Developments and Proposed Acquisitions:** To the extent material, the likely consequences of material recent developments may be disclosed in the “summary box” or the Management’s Discussion and Analysis. For example, it is customary to discuss a material recent or proposed acquisition in the MD&A section of the offering document, whether or not audited financials of the acquired or to-be-acquired business are required to be presented. This practice will often result in a discussion of the impact of pending or recent acquisitions on margins, debt levels, etc., in a section of the MD&A labeled “Overview” or “Impact of the Acquisition” or a similar title. The textual disclosure may include a discussion of any special charges or anticipated synergies expected to result from the acquisition or other pending event.

### III. Age of Financial Statements

Understanding the timing requirements for the provision of financial statements is as critical as understanding the scope of the financial information required. The determination of when financial statements go “stale” is sure to come up at the all-hands meeting and planning to have the necessary financial information prepared on time is an essential part of the offering process. An important development in 2002 was the introduction of the “accelerated filer”

When do the audited financial statements go stale?

The staleness of audited financial statements is measured from the date of effectiveness of the registration statement (or, by analogy, the pricing date of a Rule 144A offering). Generally, S-X 3-01 and S-X 3-12 provide that if the registration statement is filed by a 1934 Act reporting company and the effective date of the registration statement is less than 90 days after the end of the fiscal year (in other words, prior to March 31 for a December 31 fiscal year end filer), then the registration statement only needs to include financial statements as of the end of the third fiscal quarter of the most recently ended fiscal year, unless:

- the audited financials for the most recently ended fiscal year are available, or
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- the effective date is more than 45 days after the end of the fiscal year (in other words, after February 14 for a December 31 fiscal year end filer) and the filer is a “loss corporation.” A loss corporation is a company that does not expect to report positive income after taxes but before extraordinary items and the cumulative effect of a change in accounting principle for the most recently ended fiscal year and for at least one of the two prior fiscal years.

The 90-day period for eligible issuers that are accelerated filers (which includes most Form S-3 eligible companies) is being reduced over the next several years, as set forth in the chart below.

<table>
<thead>
<tr>
<th>Relevant Fiscal Year End for Accelerated Filers</th>
<th>Date That Nine-Month Financials Go Stale</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fiscal years ending before December 15, 2003</td>
<td>90 days (i.e., after March 30, 2003 for an issuer with a December 31, 2002 fiscal year end)</td>
</tr>
<tr>
<td>Fiscal years ending on or after December 15, 2003 and before December 15, 2004</td>
<td>75 days (i.e., after March 14, 2004 for an issuer with a December 31, 2003 fiscal year end)</td>
</tr>
<tr>
<td>Fiscal years ending on or after December 15, 2004</td>
<td>60 days (i.e., after February 28 of 2005 and each year thereafter 11 for an issuer with a December 31 fiscal year end)</td>
</tr>
</tbody>
</table>

The 90-day staleness date is being retained only for companies that are not accelerated filers.

Initial public offerings are subject to an added wrinkle. S-X 3-12(d) provides that the most recent audited financial statements in an IPO registration statement cannot be more than one year and 45 days old when the registration statement becomes effective. The impact of this rule is that for companies with a December 31 fiscal year end that are not already public, it is not possible for a registration statement to become effective after February 14 of a year until financial statements have been completed for the just-ended fiscal year. As a result, first-time issuers find their offerings pushed to March if they cannot complete their year-end audits by February 14.

In all circumstances the registration statement must be updated to include any audited financials that become available before the anticipated effective date. In other words, registrants are required to include any audited or interim financials that are completed and available prior to the staleness date.

Companies with audited financial statements for the period ending on December 31 will always need to update their financial statements for the first quarter if the offering takes place on or after the issuer’s filing deadline for reporting its quarterly results in May (with the exact date depending on whether the issuer is an accelerated filer). 12
When do the unaudited financial statements go stale?

The staleness of unaudited financial statements is measured from the date of the most recent financial statements included in the registration statement. S-X 3-12(a) provides that if the financial statements in a registration statement would be more than 135 days old when the registration statement is declared effective (i.e., more than approximately 45 days has passed since the end of the most recently ended fiscal quarter), then the interim financial statements must be updated to include the most recently completed quarter. These updated unaudited interim financials must include a balance sheet as of the end of the most recently completed quarter and income statements, cash flow statements, and statements of stockholders’ equity for the three-, six-, or nine-month interim period (as applicable) that ends with the most recently completed quarter and the corresponding three-, six- or nine-month period of the prior fiscal year.

The 135-day period for accelerated filers is also being reduced over the next few years, as set out in the chart below.

<table>
<thead>
<tr>
<th>Relevant Fiscal Year End for Accelerated Filers</th>
<th>Date That 1st and 2nd Quarter Financials Go Stale</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fiscal years ending before December 15, 2004</td>
<td>135 days (i.e., after August 12, 2003 for first quarter financial statements and after November 11, 2003 for second quarter financial statements)</td>
</tr>
<tr>
<td>Fiscal years ending on or after December 15, 2004 and before December 15, 2005</td>
<td>130 days (i.e., after August 7, 2004 for first quarter financial statements and after November 6, 2004 for second quarter financial statements)</td>
</tr>
<tr>
<td>Fiscal years ending on or after December 15, 2005</td>
<td>125 days (i.e., after August 2 for first quarter financial statements and after November 1 for second quarter financial statements)</td>
</tr>
</tbody>
</table>

S-X 3-12(a) also provides that the interim financial statements in the offering document must be at least as current as the most recent financial statements filed with the SEC on Form 10-Q. As a result, if an issuer has filed its Form 10-Q early, its offering document will be required to be updated to include the quarterly financial information included in that Form 10-Q.

Companies that are not accelerated filers and do not file 10-Qs early will continue to have 135 days before their interim financial statements go stale.
For any of the time frames noted above, if the last day before the financials go stale is a Saturday, Sunday or holiday, Rule 417 of the 1933 Act allows the filing to be made on the next business day, effectively postponing the staleness date.

As is the case with audited financial statements, the registration statement must always be updated to include any interim financials that become available before the effective date.

IV. Financial Statements for Periods of Less than One Year

Compliance with the various financial statements requirements is facilitated by an important exception under S-X 3-06. Whenever audited financial statements are required for a period of one, two or three years, a single audited period of 9 to 12 months may count as a year if:

- the issuer has changed its fiscal year during the period,
- the issuer has made a significant business acquisition for which financial statements are required under S-X 3-05 and the financial statements covering the interim period pertain to the business being acquired, or
- the SEC grants permission to do so under Rule 3-13, provided that financial statements are filed that cover the full fiscal year or years for all other years in the time period (note, however, that this permission is rarely granted).

Under this rule, the SEC will accept financial statements for periods of not less than 9, 21 and 33 consecutive months as substantial compliance with the requirement to provide financial statements for one, two and three years, respectively.

V. Financial Statements for Recent and Probable Acquisitions

S-X 3-05 generally requires the inclusion of audited financial statements for a significant acquisition of a “business” that has closed, or as soon as the acquisition becomes “probable” in cases where the transaction is at the highest level of significance (as discussed below). S-X 11-01 generally requires pro forma financial information for the most recent fiscal year and most recent interim period where a material acquisition has occurred or is “probable.” The term “business” is defined in S-X 11-01(d) to include an operating entity or business unit, but excludes machinery and other assets that do not generate a distinct profit or loss stream. Acquisitions of related businesses are treated as a single acquisition for purposes of the significance tests. Businesses are considered “related” if they are owned by a common seller, under common management, or their acquisitions are conditional upon each other or a single common event. The term “probable” is interpreted to mean more likely than not. The SEC staff has taken the general view that an acquisition becomes probable upon the signing of a letter of intent.
Whether financial statements for recent and probable acquisitions must be included in the filing also depends upon the “significance” of the acquisition. Significance of an acquired business is evaluated under S-X 1-02(w) based upon three criteria:

- the amount of the issuer’s investment in the acquired business compared to the issuer’s total assets,
- the total assets of the acquired business compared to the issuer’s total assets, and
- the pre-tax income\textsuperscript{16} from continuing operations of the acquired business compared to the issuer’s pre-tax income from continuing operations,

in each case, based on the issuer’s most recent audited financial statements. However, if the issuer has made a significant acquisition subsequent to the latest fiscal year end and filed a report on Form 8-K that included all of the financial statements for the periods required by S-X 3-05, the test may, at the issuer’s option, be based upon the \textit{pro forma} amounts for the latest fiscal year included in the Form 8-K rather than the historical amounts for the latest fiscal year.

Generally:

- if the acquired business exceeds 20\% of any of the three significance criteria, then one year of audited financial information is required, as well as the interim financial information that would be required under S-X 3-02,
- if more than 40\%, then two years of such audited and interim financial information, and
- if more than 50\%, three years of such audited and interim financial information.

Whenever audited financial statements are required, Article 11 of Regulation S-X requires:

- a \textit{pro forma} condensed balance sheet as of the end of the most recent period for which a consolidated balance sheet is required, and
- a \textit{pro forma} condensed income statement for the most recent fiscal year and the most recent interim period.

The table on the following page summarizes the financial statement requirements in connection with acquisitions.
<table>
<thead>
<tr>
<th>Acquisition Scenario</th>
<th>Reporting Requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Individual acquisition at or below the 20% significance level.</td>
<td>1. No requirement to include audited financials in the offering document.</td>
</tr>
<tr>
<td>2. Individual acquisition (or multiple acquisitions of “related businesses,” as described above) in excess of the 20% significance level, but not above the 40% level.</td>
<td>2. Audited financials for the most recent fiscal year and unaudited financials for any interim periods will be required, as specified in S-X 3-01 and 3-02.</td>
</tr>
<tr>
<td>3. Multiple acquisitions of unrelated businesses below the 20% significance level individually, but aggregating in excess of the 50% level of significance.</td>
<td>3. Audited financials for the most recent fiscal year and any interim periods required for a substantial majority of the individually insignificant acquisitions required in the offering document.</td>
</tr>
<tr>
<td>4. Individual acquisition (or multiple acquisitions of “related businesses,” as described above) in excess of the 40% significance level, but not above the 50% level.</td>
<td>4. Audited financials for the two most recent fiscal years (including one balance sheet) and any interim periods required.</td>
</tr>
<tr>
<td>5. Individual acquisition above the 50% significance level.</td>
<td>5. Three years of audited financial statements (including two balance sheets) and any interim periods required for all completed and probable acquisitions at this level of significance. However, financial statements for the earliest of the three fiscal years required may be omitted if net revenues reported by the acquired business in its most recent fiscal year are less than $25 million.</td>
</tr>
<tr>
<td>6. Securities being registered in an offering to stockholders of the acquired company (such as a stock-for-stock merger).</td>
<td>6. Three years of financial statements (including two balance sheets) of the business to be acquired in the transaction are generally required and in most cases the most recent fiscal year must be audited.</td>
</tr>
</tbody>
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One notable exception to these rules is that below the 50 percent significance level, no audited financial statements are required in the offering document for probable acquisitions or for completed acquisitions consummated up to 74 days before the date of the offering. However, industry practice is to include financials for any acquisition above the 20 percent threshold as soon as it has become probable and the commitment committees of most investment banks will likely require at least a one-year audit, even if the 74-day grace period has not yet expired.

Compliance with these rules is also facilitated by the S-X 3-06 exception that allows a single audited period of 9 to 12 months to count as a year for an acquired business.

Staff Accounting Bulletin No. 80 provides a special interpretation of S-X 3-05 for initial public offerings involving businesses that have been built by the aggregation of discrete businesses that remain substantially intact after acquisition (i.e., industry roll-ups). SAB 80 allows first-time issuers to consider the significance of businesses recently acquired or to be acquired based on the pro forma financial statements for the issuer’s most recently completed fiscal year. While compliance with this interpretation requires an application of SAB 80’s guidance and examples on a case-by-case basis, the policy is to allow currently insignificant business acquisitions to be excluded from the financial statement requirements while still ensuring that the registration statement will include not less than three, two and one year(s) of financial statements for not less than 60 percent, 80 percent and 90 percent, respectively, of the constituent businesses of the issuer.

The “ staleness” of financial statements of recently or soon-to-be acquired businesses are measured in the same manner as for the issuer itself, as described above under “Age of Financial Statements,” except that the accelerated filer schedule does not apply to S-X 3-05.

Notwithstanding the requirements outlined above, under S-X 3-05(b)(4)(iii), separate financial statements for the acquired business do not need to be presented once the operating results of the acquired business have been reflected in the audited consolidated financial statements of the registrant for a complete fiscal year (a full audit cycle) unless the financial statements have not been previously filed by the issuer or unless the acquired business is of such significance to the registrant that omission of such financial statements “would materially impair an investor's ability to understand the historical financial results of the registrant.”

Whenever historical financial statements of an acquired business (or probable acquisition) are included in the offering document, the registrant should consider whether a separate MD&A section discussing those financial statements is appropriate. Although there is no specific line item requiring that a second MD&A be included, it is not uncommon for registrants to interpret 1933 Act Rule 408 as requiring a full discussion and analysis of the financial statements of an acquired business (or probable acquisition), particularly where it exceeds 50% on any of the three significance criteria discussed above.
The acquisition or probable acquisition of operating real estate property is subject to an additional set of disclosure requirements under S-X 3-14. S-X 3-14 addresses income-producing real estate such as apartment houses and shopping malls. (In comparison, where real estate is incidental to the service provided by a business, such as a hotel, the S-X 3-05 requirements would apply.) Generally, S-X 3-14 requires that audited income statements must be provided for the three most recent fiscal years for any such acquisition or probable acquisition that would account for 10 percent or more of the issuer’s total assets. S-X 3-14 also prescribes certain variations from the typical form of income statement and allows for only one year of income statements to be provided if the property is not acquired from a related party and certain additional textual disclosure is made.22

VI. Investments Accounted for Under the Equity Method and Non-Consolidated Subsidiaries

S-X Rule 3-09 generally requires that the offering document include audited financial statements for significant investments in 50 percent-or-less-owned businesses that are accounted for under the equity method. Significance for this purpose is evaluated under two of the S-X 1-02(w) significance criteria:

- the amount of the issuer’s investment in and advances to the investee compared to the total assets of the issuer, and
- the equity of the issuer in the pre-tax income from continuing operations compared to that income of the issuer,

in each case, based on the issuer’s most recent audited financial statements. Full audited financial statements as of the same dates and for the same periods as the issuer’s audited financial statements are required where the equity investee meets either of the two criteria above at the 20 percent or greater significance level. Similarly, full audited financial statements as of the same dates and for the same periods as the issuer’s audited financial statements are required where a non-consolidated subsidiary meets any of the three S-X 1-02(w) criteria at the 20 percent significance level. For equity investees or non-consolidated subsidiaries which meet any of the three S-X 1-02(w) criteria at the greater than 10 percent but not more than 20 percent significance level, S-X 4-08(g) requires the presentation of summary financial information as described by S-X 1-02(bb).23

VII. Guarantor Financial Statements

A guarantee of a debt or preferred equity security is itself a security that must be registered under the 1933 Act, absent an applicable exemption.24 As a result, under S-X 3-10(a), the general rule is that guarantors are required to present the same financial statements as the issuer of the guaranteed securities. Fortunately, S-X 3-10(b) – (g) contain a number of important exceptions that permit registrants to disclose financial information about guarantors in a summary format using a footnote to their financial statements. Although the footnote approach can involve a fair amount of effort, it is far less burdensome than providing separate audited financial statements for every guarantor, which would of course be prohibitively expensive in many cases. S-X 3-10(e) and (f) go
even further, dispensing with any additional information requirement for guarantors in the case of a parent company issuer that does not have independent assets or operations if all of the non-guarantor subsidiaries are “minor.” In the chart below, we review the provisions of Rule 3-10 of Regulation S-X as they apply to the following five common situations:

- Parent company issuer of securities guaranteed by one or more subsidiaries,
- Operating subsidiary issuer of securities guaranteed by parent company,
- Finance subsidiary issuer of securities guaranteed by parent company,
- Subsidiary issuer of securities guaranteed by parent company and one or more other subsidiaries of parent company, and
- Recently acquired subsidiary issuer or subsidiary guarantor.

<table>
<thead>
<tr>
<th>Guarantee Scenario</th>
<th>Financial Statement Requirements</th>
</tr>
</thead>
</table>
| 1. Parent company issuer of securities guaranteed by some or all of issuer’s subsidiaries  
- The subsidiary guarantors are 100% owned by the parent company issuer,  
- The guarantee is full – the amount of the guarantee may not be less than the underlying obligation,  
- The guarantee is unconditional – holders must be able to take immediate action against the guarantor after a default on the underlying obligation, and  
- The guarantees are joint and several (if there are multiple guarantors). | 1. No separate financial statements for subsidiaries required under S-X 3-10(e) and (f) if the parent’s financial statements are filed for the periods required and they include an audited footnote with condensed, consolidating financial information for each such period, with separate columns for:  
- The parent company,  
- The subsidiary guarantor (or subsidiary guarantors on a combined basis),  
- Any non-guarantor subsidiaries on a combined basis,  
- Consolidating adjustments, and  
- Total consolidated amounts. |

Note 2 to S-X 3-10(e) and Note 1 to S-X 3-10(f) allow a conditional exemption from providing the footnote if the parent company has no independent assets or operations, the non-guarantor subsidiaries are “minor”, and there is a footnote to this effect in the parent financial statements that also notes that the guarantees are full and unconditional and joint and several. Under S-X 3-10(h)(5), a parent company has “no independent assets or operations” if each of its total assets, revenues, income from continuing operations before income taxes, and cash flows from operating activities (excluding amounts related to its investment in its consolidated subsidiaries) is less than 3% of the corresponding consolidated amount.
<table>
<thead>
<tr>
<th>Guarantee Scenario</th>
<th>Financial Statement Requirements</th>
</tr>
</thead>
</table>
| 2. Operating subsidiary issuer of securities guaranteed by parent company<sup>31</sup>  
- The operating subsidiary issuer is 100% owned by the parent company guarantor,  
- The guarantee is full and unconditional,  
- No other subsidiary of the parent is a guarantor. | 2. No separate financial statements for operating subsidiary required under S-X 3-10(c) if the parent’s financial statements are filed for the periods required and they include an audited footnote with condensed, consolidating financial information<sup>32</sup> for each such period, with separate columns for:  
- The parent company,  
- The operating subsidiary issuer,  
- Any non-guarantor subsidiaries on a combined basis,<sup>33</sup>  
- Consolidating adjustments, and  
- Total consolidated amounts.  

*This exception is also available if an operating subsidiary issuer meets these requirements except that the parent is a co-issuer with the subsidiary, rather than a guarantor.* |
| 3. Finance subsidiary issuer of securities guaranteed by parent company<sup>34</sup>  
- The finance subsidiary issuer is 100% owned by the parent company guarantor,  
- The guarantee is full and unconditional,  
- No other subsidiary of the parent is a guarantor. | 3. No separate financial statements for finance subsidiary required under S-X 3-10(b) if the parent’s financial statements are filed for the periods required and they include an audited footnote with:  
- A statement that the finance subsidiary issuer is a 100% owned finance subsidiary of the parent and the parent has fully and unconditionally guaranteed the securities, and  
- Additional disclosure under S-X 3-10(b)(4) relating to limitations on the ability of the issuer and guarantor to obtain dividends and loans from their subsidiaries.  

*This exception is also available if a finance subsidiary issuer meets these requirements except that the parent is a co-issuer with the subsidiary, rather than a guarantor.* |
Guarantee Scenario

4. Subsidiary issuer of securities guaranteed by parent company and one or more other subsidiaries of parent company – applies to both operating and finance subsidiaries
   - The issuer and all subsidiary guarantors are 100% owned by the parent company guarantor,
   - The guarantees are full and unconditional, joint and several,\(^{35}\) and
   - No other subsidiary of the parent is a guarantor.

5. Recently acquired subsidiary issuer or subsidiary guarantor
   - The subsidiary has not been included in the audited consolidated results of the parent company for at least nine months of the most recent fiscal year, and
   - The purchase price or net book value (as of the most recent fiscal year end prior to the acquisition), whichever is greater, of the subsidiary (or group of subsidiaries that were related prior to the acquisition) is 20% or more of the principal amount of the securities being registered.

Financial Statement Requirements

4. No separate financial statements for subsidiaries required under S-X 3-10(d) if the parent’s financial statements are filed for the periods required and they include an audited footnote with condensed, consolidating financial information\(^{36}\) for each such period, with separate columns for:
   - The parent company,
   - The subsidiary issuer,
   - The guarantor subsidiaries on a combined basis,
   - Any non-guarantor subsidiaries on a combined basis,\(^{37}\)
   - Consolidating adjustments, and
   - Total consolidated amounts.

This exception is also available if a subsidiary issuer meets these requirements except that the parent is a joint and several co-issuer with the subsidiary, rather than a guarantor.

5. Separate financial statements required under S-X 3-10(g) for each such subsidiary, including:
   - Audited financial statements for the subsidiary’s most recent fiscal year prior to the acquisition, and
   - Unaudited financial statements for the interim periods specified in S-X 3-01 and 3-02 (balance sheet as of the end of the most recently ended fiscal quarter and income statements and cash flow statements for the corresponding current and prior year periods).\(^{38}\)

Requirements apply even if (1) the recently acquired subsidiary would otherwise be eligible for the use of condensed consolidating footnote presentation or (2) S-X 3-05 would not require financial statements.
VIII. Financial Statements for Secured Offerings

Rule 3-16 of Regulation S-X generally requires separate audited and interim financial statements for an issuer’s affiliate if the securities of that affiliate are pledged as collateral for the offering and those securities constitute a “substantial portion” of the collateral for the securities being registered. Securities of the affiliate are deemed to constitute a “substantial portion” of the collateral if the aggregate principal amount, par value, or book value of the pledged securities (as carried by the issuer), or the market value of the pledged securities, whichever is the greatest, equals 20% or more of the principal amount of the securities that are being secured. If this test is met, the affiliate must file the same financial statements that it would be required to file if it were the issuer. However, the affiliate’s financial statements do not need to be filed if they are otherwise separately included (which may be through incorporation by reference, if incorporation is otherwise permitted) in the filing individually or consolidated with the affiliate’s subsidiaries.

IX. Segment Reporting

In addition to all the consolidated financial information required to be included in an offering document, companies in more than one line of business may also be required to include separate revenues and operating data for each line of business. This requirement is a function of whether the company’s business is comprised of more than one “segment.” Item 303(b) of Regulation S-X and Item 101(b) of Regulation S-K require certain financial reporting and textual disclosure for each “segment” as defined by generally accepted accounting principles. Statement of Financial Accounting Standards No. 131, “Disclosures About Segments of an Enterprise and Related Information,” provides detailed guidance for when a business constitutes an operating segment and how its discrete financial information must be reported. Generally, an operating segment is a component of a larger enterprise:

- That engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same enterprise),
- Whose operating results are regularly reviewed by the enterprise’s chief operating decision maker\textsuperscript{39} to make decisions about resources to be allocated to the segment and assess its performance, and
- For which discrete financial information is available.

The aim of segment reporting is to align public financial reporting with a company’s internal reporting in order to permit financial analysts and the public to see the overall enterprise the way management sees it. Whether an issuer considers its enterprise as having more than one segment is highly fact specific and depends on factors such as economic similarity, the similarity of the products or services sold, the nature of the production process, customer type, distribution methods, and the regulatory environment for the business. The determination is very subjective and is often the subject of much discussion with the company’s accountants and, through the SEC comment process, with the SEC. The most critical factor in determining whether an issuer has more than one segment is how management runs its business.\textsuperscript{40}
Once a segment has been identified, the issuer must provide information about the segment if it meets any of the following 10% thresholds:

- Its reported revenue (including both sales to external customers and intersegment sales) is 10% or more of the combined revenue (internal and external) of all reported operating segments.

- The absolute amount of its reported profit or loss is 10% or more of the greater, in absolute amount, of (1) the combined profit of all operating segments that did not report a loss or (2) the combined loss of all operating segments that did report a loss.

- Its assets are 10% or more of the combined assets of all operating segments.

A company with more than one segment in excess of these size requirements must disclose for each such segment the revenues from external customers, a measure of profit or loss and the total assets attributable to that segment, as well as a reconciliation to the corresponding consolidated amounts. Additional information on items such as equity investments and capital expenditures may be required under SFAS 131 if such amounts are reviewed by the company on a segment basis. For interim periods, disclosure must include a measure of profit or loss for each segment, reconciliations and material changes to total assets. Financial disclosure for segments will typically be included in the financial statements and be cross-referenced as part of a discussion on operating segments in MD&A. The effect of these requirements is to force disclosure of profitability by segment, which many issuers are reluctant to do for competitive reasons.

The identification and reporting of financial information for operating segments will be critical in the offering process as the time to prepare such information, the effect on textual disclosure and the impact on enterprise valuation may all be significant. Although the requirement for segment reporting is usually first considered only when a company is issuing securities for the first time, the issue should be revisited if the company has entered into new business lines or if management has begun to analyze its business in a new way that may impact the original segment analysis. Because the guidance of SFAS 131 is complex and its application very fact-specific, it is important to begin an early dialogue with the accountants when there may be segment reporting issues.

X. Industry Guides

Pursuant to S-K Item 801, the SEC publishes the following six industry guides which require enhanced financial and operational metrics disclosure for certain industries. This information is required from any company that engages in these activities.

- Disclosure of Oil and Gas Operations – disclosure requirements include reserve estimates, sales and production costs per unit, numbers of productive wells, developed and undeveloped acreage, drilling activity, and delivery commitments

- Statistical Disclosure by Bank Holding Companies – disclosure requirements include analyses of interest earnings, investment and loan portfolios, loan loss experience, deposit types, returns on equity and assets, and short-term deposits
Prospectuses Relating to Interests in Oil and Gas Programs – requires enhanced disclosure relating to the offering terms and participation in costs and revenues among investors and others, as well as a 10-year financial summary of any drilling programs by the registrant and its associates, including recovery on investment for investors in those programs

Preparation of Registration Statements Relating to Interests in Real Estate Limited Partnerships – requires a summary of the financial performance of any other real estate investment programs sponsored by the general partner and its affiliates

Disclosure Concerning Unpaid Claims and Claim Adjustment Expenses of Property-Casualty Insurance Underwriters – requires details of reserves and historical claim data if reserves for unpaid property casualty claims and claim adjustment expenses of the issuer, its consolidated and unconsolidated subsidiaries and equity investees exceed 50 percent of the common stockholders' equity of the issuer and its consolidated subsidiaries

Description of Property by Issuers Engaged in Significant Mining Operations – requires details of proven and probable reserves and mining operations

Compiling the information required by these industry guides may be a significant undertaking, and the auditors should coordinate with the issuer’s financial and operating management early in the process if an industry guide applies to your offering.

XI. Supplemental Schedules

S-X 5-04 requires a number of supplemental schedules for particular industries and circumstances. Each schedule contains additional financial information that must be audited and provided with the offering document. The schedules include:

- Schedule I – Condensed Financial Information of Registrant (known as parent-only financial statements) – requires condensed balance sheets and statements of income and cash flows on a non-consolidated basis if as of the end of the latest fiscal year the amount of restricted net assets of subsidiaries exceeds 25 percent of the issuer’s consolidated assets. “Restricted net assets” are the issuer’s proportionate share of net assets of consolidated subsidiaries (after intercompany eliminations) which as of the end of the most recent fiscal year may not be transferred to the parent company by subsidiaries in the form of loans, advances or cash dividends without the consent of a third party (i.e., lender, regulatory agency, foreign government, etc.).

- Schedule II – Valuation and Qualifying Accounts – requires an analysis of each valuation and qualifying account (e.g., allowance for doubtful accounts, allowance for obsolescence).

- Schedule III – Real Estate and Accumulated Depreciation – requires real estate operating and investment companies to disclose certain financial details regarding each of their properties.

- Schedule IV – Mortgage Loans on Real Estate – requires real estate operating and investment companies to disclose details of each mortgage loan which accounts for three percent or more of the carrying value of all of the issuer’s mortgages.

- Schedule V – Supplemental Information Concerning Property-Casualty Insurance Operations – requires disclosure as to liabilities on property-casualty insurance claims if the issuer, its subsidiaries or 50%-or-
less owned equity basis investees have such liabilities; however, the schedule may be omitted if reserves for unpaid property-casualty claims and claims adjustment expenses did not, in the aggregate, exceed 50 percent of common stockholders' equity of the issuer and its consolidated subsidiaries as of the beginning of the fiscal year.

XII. Special Considerations in Rule 144A Transactions

The disclosure document in a Rule 144A offering is typically modeled after its first cousin, the public prospectus. In most situations, the commitment committees of the major investment banks will insist on including financial disclosure in the 144A offering circular that is in all material respects consistent with the financial statement requirements that would be applicable to a registration statement filed with the SEC. Rule 144A offerings are typically sold off the desk to buyers who expect the same level of disclosure that they would receive in a public deal. Additionally, since the 144A offering circular is likely to be followed in a matter of weeks by a registered exchange offer prospectus, and the buyers of the offered securities will thereby receive full 1933 Act disclosure shortly after the closing, most practitioners elect to provide substantially the same disclosure to prospective purchasers before the closing as well whenever possible. Therefore, 144A offering circulars typically follow the public offering rules described above in all material respects.

It is not uncommon, however, for a working group on a Rule 144A deal to decide to dispense with a particular financial statement requirement if the group determines that that particular item will not materially alter the total mix of information provided. After all, Rule 144A(d)(4)'s information requirements are very modest and they only call for "the issuer's most recent balance sheet and profit and loss and retained earnings statements, and similar financial statements for such part of the two preceding fiscal years as the issuer has been in operation (the financial statements should be audited to the extent reasonably available)." A more flexible approach can also be justified by the fact that the liability standards of Sections 11 and 12 of the 1933 Act do not apply to Rule 144A deals. Although Rule 10b-5 does apply to Rule 144A offerings, it is much more difficult for disgruntled purchasers to demonstrate the requisite "scienter" required to establish a valid 10b-5 claim. As a result, for example, it is not uncommon to provide only two years of audits in a Rule 144A transaction where a registration statement would require three years. This is true for the issuer and for material acquired businesses. We have seen this decision taken in a number of deals, particularly where the issuer is already in its third or fourth fiscal quarter, since the third year of audits will likely be completed in the natural course before the exchange offer registration statement is required to be filed. Other working groups have elected to exclude some of the finer elements of the financial information requirements where they have determined that such additional information would not materially alter the total mix of information presented. Examples include some of the details of the required guarantor footnotes described above and some of the details of executive compensation. Although the industry custom is to follow the public offering rules as if they were applicable to the 144A deal, there is no requirement in Rule 144A to do so and some working groups will conclude that not every detail of the information called for in a registration statement is required to present 144A investors with full and fair disclosure.
XIII. Special Rules Applicable to Foreign Private Issuers

The financial statement requirements for foreign private issuers differ in a number of significant ways from those of domestic U.S. issuers. We summarize these briefly below:

**Foreign private issuers may use IAS, local GAAP or U.S. GAAP but must reconcile to U.S. GAAP**

The financial statements of foreign private issuers may be prepared using either U.S. GAAP, International Accounting Standards (IAS) or local “home country” GAAP. If IAS or local GAAP is used, the consolidated financial statements (both annual and interim) must include a reconciliation to U.S. GAAP. The registration statement must also include disclosure of the material differences between IAS or the local GAAP used, and U.S. GAAP.

**Foreign private issuers may be required to provide less than three years of audited financial statements under certain circumstances**

Foreign private issuers are normally required to provide audited financial statements for the three most recent fiscal years, except that if a jurisdiction outside the United States does not require a balance sheet for the earliest year of the three-year period, that balance sheet may be omitted. In addition, in an initial registration statement, if the financial statements are presented in accordance with U.S. GAAP (rather than reconciled to U.S. GAAP), the earliest of the three years of financial statements may be omitted if that information has not previously been included in a filing made under the 1933 Act or the 1934 Act.

**Foreign private issuers do not provide quarterly interim financial information**

The interim financial statement requirements differ for foreign private issuers. If the registration statement becomes effective more than nine months after the end of the last audited financial year, a foreign private issuer must provide interim consolidated financial statements (which may be unaudited, but must either be reconciled to, or prepared in accordance with, U.S. GAAP) covering at least the first six months of the fiscal year. The interim financial statements may be presented on a condensed basis and should include an interim balance sheet, interim income statement, interim cash flow statement, interim statement of changes to equity and selected note disclosures. However, if the issuer prepares or is required to prepare more current financial statements locally, then these must be included in the registration statement. In addition, foreign private issuers that choose to file on the same forms as U.S. issuers (e.g., S-3 instead of F-3) are not exempted from providing quarterly interim financial information.

**Foreign private issuers are not subject to accelerated filing and their financial statements go “stale” more slowly**

Foreign private issuers are exempt from the accelerated filing requirements applicable to domestic issuers. Accordingly, the financial statements of foreign private issuers go “stale” more slowly than do those of domestic issuers.
If the registration statement becomes effective more than three months after the end of the issuer’s most recent fiscal year, then audited financial statements with respect to that fiscal year must be included in the filing. However, if the registration statement relates to an initial public offering, the audited financial statements must generally be as of a date not older than 12 months prior to the time the document is filed (subject to certain exceptions). However, if a foreign private issuer elects to use the same forms as U.S. issuers and follow the reporting requirements for U.S. issuers, then the issuer will be subject to accelerated filing requirements for each quarterly and annual report filed under Section 13(a) or 15(d) of the 1934 Act.

Foreign private issuers need not report in U.S. dollars

Foreign private issuers may state amounts in their financial statements in any currency they deem appropriate, but only one currency may be used. If the reporting currency is not U.S. dollars, then U.S. dollar-equivalent financial statements or convenience translations may be included, but only for the most recent financial year and interim periods.

XIV. Conclusion

Knowing what financial statements will be required to complete a particular financing and when they go “stale” is critical in planning a financing. This Practice Guide is designed to provide a road map to the answers to those questions in the typical cases that we face every day. Of course, in any particular case, securities counsel and the auditors will need to be consulted to confirm your analysis.

Please feel free to call Kirk A. Davenport at 1-212-906-1284, Alexander F. Cohen at +44-20-7710-1014, Adam B. Cohen at 1-212-906-1235 or John J. Huber at 1-202-637-2242 if you have any questions about the matters raised in this Practice Guide. Also, of course, feel free to call any of the lawyers listed on the back cover of this Practice Guide or any other Latham lawyer.
The financial statement requirements discussed in this Practice Guide also apply to registration statements on Form 10 for the spin-off of shares of a subsidiary to the existing shareholders of a public company.

Under Item 301(a) of Regulation S-K, the selected financial data must include at least each of the following line items: net sales or operating revenues, income (loss) from continuing operations, income (loss) from continuing operations per common share, total assets, long-term obligations and redeemable preferred stock, and cash dividends declared per common share. The selected financial data may also include any additional items that would enhance an understanding of the issuer’s financial condition and results of operations.

Where information is required for a certain number of years, it is sufficient to provide information for the life of the registrant and its predecessors if they have been in existence for less than the prescribed number of years. Whenever audited financial statements are required for a period of one, two or three years, S-X 3-06 allows an audited period of 9 to 12 months to count as one (but only one) of the required years, but only if:

- the issuer has changed its fiscal year during the period,
- the issuer has made a significant business acquisition for which financial statements are required under S-X 3-05 and the financial statements covering the interim period pertain to the business being acquired, or
- the SEC grants permission to do so.

Under Item 302(a) of Regulation S-K, the quarterly supplementary financial information must include at least each of the following line items: net sales, gross profit (net sales less costs and expenses associated directly with or allocated to products sold or services rendered), income (loss) before extraordinary items and cumulative effect of a change in accounting, per share data based upon such income (loss), and net income (loss). This information is typically incorporated by reference rather than presented in the offering document, when permitted. In 144A transactions this information is rarely provided.

Under Item 503(d) of Regulation S-K, any registration statement covering debt securities must include the ratio of earnings to fixed charges and any registration statement covering preferred stock must include the ratio of combined fixed charges and preference dividends to earnings. If the proceeds from the sale of debt or preferred equity will be used to repay outstanding debt or to retire other securities and the change in the ratio would be 10% or greater, a pro forma ratio must be included for the most recent fiscal year and the latest interim period presented.

Pro forma financial information is required under S-X 11-01 in connection with a significant business acquisition or disposition, if the issuer was previously part of another entity, and in certain other circumstances. S-X 11-02 prescribes the form and content of the pro forma information.

Generally, Form S-2 may be used by an issuer that has been subject to the 1934 Act reporting requirements for at least 36 months; has timely filed all 1934 Act reports for the 12 months prior to registration; and has not had any material defaults relating to dividend or sinking fund installments on preferred stock, installments on indebtedness, or rentals under long-term leases since the end of the last fiscal year. Generally, Form S-3 may be used by an issuer to sell non-convertible investment grade securities or other securities (provided that the issuer has at least $75 million of common equity outstanding held by non-affiliates) if the issuer has been subject to the 1934 Act reporting requirements and timely filed all 1934 Act reports for the 12 months prior to registration; and neither the issuer nor its subsidiaries have had any material defaults on a payment related to a dividend, sinking fund, indebtedness, or rentals under long-term leases.

In January 2003, the SEC adopted new rules limiting the use of non-GAAP financial measures that have customarily appeared in the summary financial data. See Latham & Watkins Client Alert No. 257, “SEC Adopts Rules for Disclosure of EBITDA and Other Non-GAAP Financial Measures,” for more information on this important topic.

Regulation FD prohibits discussing material information with prospective investors unless it has been made public. Some companies will issue a “recent results” press release ahead of schedule in order to allow for the inclusion of these results in the offering document and a “road show” discussion of these results with prospective investors.

An “accelerated filer” is an issuer that meets each of the following conditions as of the end of its fiscal year:

- the aggregate market value of the voting and non-voting common equity held by non-affiliates of the issuer is $75 million or more,
- the issuer has been subject to the filing requirements of Section 13(a) or 15(d) of the 1934 Act for a period of at least twelve calendar months,
- the issuer has filed at least one annual report pursuant to Section 13(a) or 15(d) of the 1934 Act, and
- the issuer is not eligible to use the small business forms (10-KSB and 10-QSB) for its annual and quarterly reports.
Leap years do not affect this determination.

For non-accelerated filers, first quarter information must be provided 45 days after the end of the quarter. For accelerated filers, first quarter financials must be provided 45 days after the end of the quarter for fiscal years ending before December 15, 2002; 40 days after the end of the quarter for fiscal years ending on or after December 15, 2004; and 35 days after the end of the quarter for fiscal years ending on or after December 15, 2005.

Numbers go stale after August 12 and November 11 for the first and second quarter, respectively, for such companies with a December 31 fiscal year end.

Whether an acquisition is of a “business” should be evaluated in light of the facts and circumstances involved and whether there is sufficient continuity of the acquired entity’s operations prior to and after the transactions so that disclosure of prior financial information is material to an understanding of future operations. A presumption exists that a separate entity, a subsidiary, or a division is a business. However, a lesser component of an entity may also constitute a business. Among the facts and circumstances which should be considered in evaluating whether an acquisition of a lesser component of an entity constitutes a business are:

- whether the nature of the revenue-producing activity of the component will remain generally the same as before the transaction, or
- whether any of the following attributes remain with the component after the transaction: (i) physical facilities, (ii) employee base, (iii) market distribution system, (iv) sales force, (v) customer base, (vi) operating rights, (vii) production techniques, or (viii) trade names.

However, a different conclusion may be reached depending upon the customary practice for an industry or a particular issuer. For example, an issuer may be submitting a letter of intent as one of many parties in a bidding process, or a roll-up entity may routinely sign letters of intent to further its due diligence investigations of multiple potential targets, but with the acquisition of only a minority of those companies becoming probable.

If the acquired business had a net loss, then the absolute value of the negative amount is generally used for the test.

Item 17 of Form S-4 provides some accommodations with respect to acquirees that are not reporting companies under the 1934 Act and in certain other cases where financial statements have previously been provided to securityholders. If the acquiree is a reporting company or if the acquiree is a non-reporting company but the issuer’s shareholders are voting, then two years of balance sheets and three years of income statements and cash flows must be provided, along with interim financial information for the latest and prior comparable interim period. If the acquiree is a non-reporting company and the issuer’s shareholders are not voting, then up to two years of financial statement may be required, depending upon the circumstances. In both cases, the financial statements must be audited if the Form S-4 is being used for resales by persons considered underwriters under Rule 415 of the 1933 Act; if not, only the latest year must be audited “to the extent practicable,” which depends on the feasibility and expense of the audit against the usefulness of the audit to the shareholders, but will ordinarily be required by the SEC.

The date of an offering will be deemed to be the date of the final prospectus or prospectus supplement filed pursuant to Rule 424(b). By analogy, the pricing date would be the date of an offering in a Rule 144A transaction.

In order for the pre-acquisition statements of an acquiree to be omitted from the registration statement, each of the following conditions must be met:

- the combined significance of businesses acquired or to be acquired for which audited financial statements cover a period of less than 9 months may not exceed 10 percent;
- the combined significance of businesses acquired or to be acquired for which audited financial statements cover a period of less than 21 months may not exceed 20 percent; and
- the combined significance of businesses acquired or to be acquired for which audited financial statements cover a period of less than 33 months may not exceed 40 percent.

Combined significance is the total, for all included companies, of each individual company’s highest level of significance under the three tests of significance (investment, assets and pre-tax income). For a serial acquirer going public, the application of SAB 80 is likely to allow for the exclusion of financial statements for an increasing number of acquired companies for each period prior to the IPO.

For example, if, at the date of acquisition, the acquired business met at least one of the conditions in the S-X 1-02 definition of significant subsidiary at the 80% level, the income statements of the acquired business should normally continue to be furnished for such periods prior to the acquisition as would, along with the issuer’s audited financials post-acquisition, cover the equivalent of the three-year period specified in S-X 3-02.
An Overview of the Financial Statement Requirements for U.S. Securities Offerings

Rule 408 states that “In addition to the information expressly required to be included in a registration statement, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading.”

The additional disclosure includes (i) material factors considered by the issuer in assessing the property, including sources of revenue (including, but not limited to, competition in the rental market, comparative rents, occupancy rates) and expense (including, but not limited to, utility rates, ad valorem tax rates, maintenance expenses and capital improvements anticipated) and (ii) an indication that, after reasonable inquiry, the issuer is not aware of any material factors relating to the property other than those discussed in (i) that would cause the reported financial information not to be necessarily indicative of future operating results.

S-X 1-02(bb) requires audited summarized financial information for the subsidiary’s current assets, noncurrent assets, current liabilities, noncurrent liabilities, redeemable preferred stock, minority interests, net sales or gross revenues, gross profit, income or loss from continuing operations before extraordinary items and cumulative effect of a change in accounting principle, and net income or loss.

S-X 3-10 only addresses “debt and debt-like securities” for which the issuer has a contractual obligation to pay a fixed sum at a fixed time, and, where the obligation is cumulative, a set amount of interest (which may be determined using an adjustable rate) must be paid. See Final Rule: Financial Statements and Periodic Reports for Related Issuers and Guarantors, Release No. 33-7878 (August 4, 2000) (http://www.sec.gov/rules/final/33-7878.htm). The rule does not apply to credit enhancements that are not guarantees. However, in certain cases the financial condition of the party providing the credit enhancement could be material to investors and subject to disclosure.

Under S-X 3-10(h)(6), a subsidiary is “minor” if each of its total assets, stockholders' equity, revenues, income from continuing operations before income taxes, and cash flows from operating activities is less than 3% of the parent company’s corresponding consolidated amount.

Under S-X 3-10(h)(1), a subsidiary is 100% owned if all of its outstanding voting shares are owned by its parent company, either directly or indirectly, including convertible securities and options to buy voting shares. A subsidiary not in corporate form is 100% owned if the sum of all interests are owned, either directly or indirectly, by its parent company, other than securities that are guaranteed by its parent and, if applicable, other 100% owned subsidiaries of its parent, and securities that guarantee securities issued by its parent and, if applicable, other 100% owned subsidiaries of its parent. Note that this standard is different from the definition of “wholly-owned subsidiary” under S-X 1-02(aa), which is “a subsidiary substantially all of whose outstanding voting shares are owned by its parent and/or the parent's other wholly-owned subsidiaries.”

The Latham & Watkins standard form indenture includes a “savings clause” to limit the guarantee to the extent necessary for the guarantee not to constitute a fraudulent conveyance under insolvency laws. This exception does not vitiate the guarantee in the view of the SEC. Guarantees may also have different subordination terms than the guaranteed security.

However, pursuant to Note 1 of S-X 3-10(f), if any of the subsidiary guarantees is not joint and several with the guarantees of the other subsidiaries, then each subsidiary guarantor whose guarantee is not joint and several need not include separate financial statements, but the condensed consolidating financial information must include a separate column for each subsidiary guarantor whose guarantee is not joint and several.

S-X 3-10(i) provides guidance for the preparation of the condensed consolidating financial information in the footnote; this information is substantially similar to the level of detail that appears in regular quarterly financial statements.

The column for non-guarantor subsidiaries may be omitted if the parent has independent assets or operations and the non-guarantor subsidiaries are minor.

A subsidiary is an operating subsidiary if it is not a finance subsidiary (as defined in endnote 34 below).

Note 1 to S-X 3-10(c) allows a conditional exemption from providing the footnote if the parent company has no independent assets or operations, the non-guarantor subsidiaries are minor, and there is a footnote to this effect in the parent financial statements that also notes that the guarantee is full and unconditional.

The column for non-guarantor subsidiaries may be omitted if the parent has independent assets or operations and the non-guarantor subsidiaries are minor.

A subsidiary is a finance subsidiary if it has no assets, operations, revenues or cash flows other than those related to the issuance, administration and repayment of the security being registered and any other securities guaranteed by its parent company.

However, pursuant to Note 4 of S-X 3-10(d), if any of the subsidiary guarantees is not joint and several with the parent company’s guarantee or the guarantees of the parent company and the other subsidiaries, then each subsidiary guarantor...
whose guarantee is not joint and several need not include separate financial statements, but the condensed consolidating financial information must include a separate column for each subsidiary guarantor whose guarantee is not joint and several.

36 For a finance subsidiary only, instead of providing this condensed consolidating financial information, pursuant to Note 5 of S-X 3-10(d), the parent company’s financial statements may include an audited footnote that the parent company has no independent assets or operations, the issuer is a 100% owned finance subsidiary, the parent company and all of the parent company’s subsidiaries other than the issuer have guaranteed the securities, and the guarantees are full and unconditional and joint and several.

37 The column for non-guarantor subsidiaries may be omitted if the non-guarantor subsidiaries are minor.

38 The audited and unaudited financial statements must comply with all aspects of Regulation S-X except for the filing of supporting schedules.

39 SFAS 131 uses the term “chief operating decision maker” to identify a function rather than a specific person; the “chief operating decision maker” could be the CEO, CFO, or a group of senior managers, depending upon the circumstances.

40 In practice there is a great variety of ways in which management may view its business and there is no one right answer within a given industry. For example, Dell Computer considers that its enterprise is primarily operating on a geographic basis, but with two operating segments in the U.S. (business and consumer); in comparison, IBM reports its results under seven operating segments based upon customers, products, technology and delivery channels.

41 Under SFAS 131, the details provided in reporting a “measure of profit or loss” depend upon the information that is actually reviewed by the chief operating decision maker and may include revenues from external vs. internal customers, interest revenue and expense, depreciation and amortization, and extraordinary items, among others.

42 Where restrictions on the amount of funds that may be loaned or advanced differ from the amount restricted as to transfer in the form of cash dividends, the amount least restrictive to the subsidiary may be used. Redeemable preferred stocks and minority interests are deducted in computing net assets for purposes of this test.

43 Under the relevant Rule 10b-5 case law, a plaintiff must show more than a simple misstatement or omission. A showing of “scienter” or recklessness is also required to establish liability.

44 A foreign private issuer is any issuer (other than a foreign government) incorporated or organized under the laws of a jurisdiction outside the United States, unless (1) more than 50% of its outstanding voting securities are directly or indirectly owned by U.S. residents and (2) either (A) the majority of its executive officers or directors are U.S. citizens or residents, (B) more than 50% of its assets are located in the United States or (C) its business is principally administered in the United States.
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