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Memorandum

SEC Adopts Welcome Changes to Required Disclosures for Acquisitions and Dispositions

May 29, 2020

On May 21, 2020, the Securities and Exchange Commission adopted changes to the financial disclosure requirements relating to the acquisition and disposition of businesses.[1] As set forth in greater detail below, these changes will greatly assist SEC reporting companies in terms of streamlining and eliminating immaterial information relating to acquisitions and dispositions and will provide additional flexibility in terms of presenting pro forma adjustments relating to such transactions. Of note, the rule amendments:

- Reduce the maximum number of years of required audited financial statements from acquired businesses from three years to two;
- Eliminate the requirement that financial statements of certain "major" acquisitions continue to be presented once the acquired company has been reflected in the registrant's operations for a full fiscal year;
- Modify the significance tests used to determine whether historical and/or pro forma financial statements for acquisitions and dispositions are required, which will reduce the likelihood of anomalous results; and
- Adopt new criteria for the presentation of pro forma adjustments, including the ability for registrants under certain circumstances to voluntarily include the impact of synergies and other adjustments that are not permitted under current SEC guidance.

The final rules will be effective on January 1, 2021, but voluntary compliance is permitted in advance of the effective date. As a result, we expect that many registrants will take advantage of the incremental flexibility afforded by these amendments immediately.

Overview of Applicable Disclosure Requirements

Currently, a registrant that acquires a business is generally required to provide up to three years of pre-acquisition financial statements of the acquired business if the acquisition is deemed "significant" under any of the investment, asset or income tests as set forth in Rule 1-02(w) of Regulation S-X. These tests have at times resulted in anomalous results that can have the effect of requiring financial disclosure for acquisitions that would not

[1] *See* Amendments to Financial Disclosures About Acquired and Disposed Businesses, Release No. 33-10786; 34-88914; IC-33872, File No. S7-05-19 (May 21, 2020).

otherwise be considered material or requiring the inclusion in a prospectus of older financial statements of an acquired business that are unlikely to be material to an investor's understanding of the combined business.[2]

In addition, Article 11 of Regulation S-X requires registrants to file unaudited pro forma financial information related to the acquisition or disposition of a significant business, which typically includes a pro forma balance sheet and pro forma income statements based on historical financial statements of the registrant and the acquired or disposed business adjusted for certain items to show how the acquisition or disposition might have affected those financial statements. The existing criteria for determining pro forma adjustments can be unclear and at times result in inconsistent presentations despite similar fact patterns.

Amendments to the Significance Tests

- *Investment Test*. Currently, the investment test compares the registrant's investment in and advances to the acquired business to the carrying value of the registrant's total assets. The adopted amendments revise the test to permit a comparison instead to the market value of a registrant's equity where ascertainable, so that a registrant compares its investments in and advances to the acquired business, which includes the fair value of contingent consideration (except for contingent consideration for which the likelihood of payment is remote), to the **average "aggregate worldwide market value" of the registrant's voting and non-voting common equity calculated daily for the last five trading days of the registrant's most recently completed month ending prior to the earlier of the registrant's announcement date or agreement date of the acquisition or disposition**.[3] If the registrant does not have an aggregate worldwide market value, the existing investment test is applied. Given that in most circumstances a registrant's equity market value will exceed its book value, this change will reduce the likelihood an acquisition will trip one of the investment test triggers (although for highly levered companies it may have the opposite impact).
- *Income Test*. Under the current test, the registrant's equity in the acquired business's income from continuing operations before taxes for the most recently completed fiscal year is compared to that of the registrant. This can produce counter-intuitive results for registrants, particularly for those whose earnings are closer to breakeven and are more likely to have a tested entity deemed significant as a result. The **amended rules add a new revenue component**, which compares the registrant's and its other subsidiaries' proportionate share of the acquired business's consolidated total revenues from continuing operations (after intercompany eliminations) to the registrant's consolidated total revenues for the most recently completed fiscal year. Significance would be met under the revised income test only if the registrant exceeds the 20% threshold for *both* the revenue and net income components. The registrant

[2] The need for an issuer to include acquired business financial statements in a prospectus has also obligated issuers to obtain consents and comfort letters from the former auditors of the acquired business when conducting SEC registered securities offerings. The amendments will likely reduce some of these transaction expenses for future offerings.

[3] This value differs from the value currently used by registrants to determine accelerated filer status under Rule 12b-2, which looks to the value of common equity held by non-affiliates and is determined as of the last business day of the registrant's' most recently completed second fiscal quarter.

would then use the lower of the revenue component and the net income component to determine the number of periods for which financial statements under Rule 3-05 of Regulation S-X ("Rule 3-05 Financial Statements") would be required. In cases where either the registrant or the acquired business does not have material revenue in each of the two most recently completed fiscal years, only the net income component will be utilized.[4]

- *Use of Pro Forma Financial Information to Measure Significance*. Currently, registrants measure significance by comparing the most recent annual consolidated financial statements of the acquired business to those of the registrant filed at or prior to the date of acquisition, which may include pro forma financial information for a significant acquisition subsequent to the latest fiscal year end that has been filed on Form 8-K in the case of non-initial registration statement filers. The adopted amendments permit **all registrants to measure significance using filed pro forma financial information for significant business acquisitions and dispositions** consummated after the latest fiscal year end for which financial statements are required to be filed, provided:
  - the registrant has filed Rule 3-05 Financial Statements or financial statements under Rule 3-14 of Regulation S-X, as applicable, for any such acquired business; and
  - the registrant has filed the pro forma financial information required by Article 11 for any such acquired or disposed business.

  Further, once a registrant uses pro forma financial information to measure significance it must continue to use pro forma financial information to measure significance until its next annual report on Form 10-K or Form 20-F.
- *Dispositions*. The adopted amendments change the significance threshold for a disposition of a business from 10% to 20% to conform to the threshold at which an acquired business is significant under Rule 3-05 of Regulation S-X and additionally conform the tests used to determine significance of a disposed business. Unlike acquisitions, dispositions of significant businesses do not require the presentation of historical financial statements for the business in question but do require the presentation of pro forma financial information under Article 11 of Regulation S-X.

Amendments to Required Audited Financial Statements for Significant Acquisitions

- *Maximum of Two Years of Historical Financial Statements*. The final amendments eliminate the requirement to include the earliest of the three years of Rule 3-05 Financial Statements for an acquisition that exceeds 50% significance.
- *Limiting Comparative Interim Period Financial Information*. For acquisitions that are significant at the 20% level but not at the 40%, **registrants will only be required to provide interim financial**

[4] In response to comments, the SEC decided not to adopt its initial proposal to calculate income or loss from continuing operations after income taxes and retained the requirement to use income or loss from continuing operations before income taxes.

statements of the acquired business for the "most recent" interim period specified in Rule 3-01 and 3-02 of Regulation S-X. This amendment eliminates the need to provide comparative interim period financial information for the prior year's interim period when only one year of audited financial statements are required.

- *Omission of Financial Statements for Acquired Businesses That Have Been Included in the Registrant's Financial Statements*. The current rules generally permit Rule 3-05 Financial Statements to be omitted once the results of the acquired business have been reflected in the audited consolidated financial statements of the registrant for a complete fiscal year. However, the current rule includes two important exceptions that extend the period for which separate Rule 3-05 Financial Statements must be filed: if they have not been previously filed[5] or if the acquired business is of "major" significance to the registrant (which in practice is considered to be at the 80% or higher significance level). **The final amendment removes these two exceptions and therefore will eliminate the requirement to include Rule 3-05 Financial Statements in registration statements and proxy statements once the acquired business is reflected in the registrant's financial statements for a period of either nine months (for acquired businesses that exceed the 20% significance level but do not exceed the 40% significance level) or a complete fiscal year (in all other cases)**.[6]

- *Modified Disclosure for Individually Insignificant Acquisitions*. Similar to the current rules, the modified rules require additional disclosure relating to multiple acquisitions of individually insignificant businesses if the aggregate impact of these businesses exceeds 50% for any of the significance tests. Registrants would still be required to provide pro forma financial information depicting the aggregate effects of the acquisition of all such businesses in all material respects[7] **but would only have to provide historical financial statements for those acquired businesses that individually exceed the 20% significance level but are not yet required to file financial statements**. Additionally, the final amendments require registrants to include both Rule 3-05 businesses and Rule 3-14 real estate operations that have been acquired when determining the aggregate impact of the investment test for individually insignificant acquisitions.

- *Modified Disclosure for Net Assets That Constitute a Business*. The adopted amendments permit registrants to provide **audited annual and unaudited interim abbreviated financial statements when acquiring a component of an entity that is a business but does not constitute a separate entity, subsidiary or division, subject to certain qualifying conditions**, including that the total assets and

[5] This is often the case for initial registration statements where the registrant acquired a significant business during the earliest of three years for which it presents financial statements, and has reported the combined results in audited financial statements since the acquisition but would still be required to file separate Rule 3-05 Financial Statements for the acquired business since they have not been previously filed.

[6] The SEC noted that if trends depicted in the registrant's financial statements are not indicative or are otherwise incomplete, Rule 4-01(a) of Regulation S-X requires that a registrant provide "such further material information as is necessary to make the required statements, in light of the circumstances under which they are made, not misleading."

[7] The amendments clarify that that the exception that would otherwise permit pro forma financial information not to be provided when separate financial statements of the acquired business are not included in the filing does not apply where the aggregate impact is significant.

total revenues of the acquired or to be acquired business constitute 20% or less of such corresponding amounts of the seller and its subsidiaries consolidated as of and for the most recently completed fiscal year.[8]

Other Amendments

- *Pro Forma Adjustment Criteria*. Under existing rules, a pro forma condensed statement of comprehensive income can only be adjusted for items that are directly attributable to the transaction, expected to have a continuing impact on the registrant and factually supportable, while a pro forma condensed balance sheet can only be adjusted for items that are directly attributable to the transaction and factually supportable. **The amendments modify this regime and create three permitted categories of pro forma adjustments: "transaction accounting adjustments," "autonomous entity adjustments" and optional "management's adjustments."** Transaction accounting adjustments include the adjustments required to reflect the accounting for the acquisition, disposition or other transaction under U.S. GAAP or IFRS-IASB, as applicable, **regardless of whether the impact is expected to be continuing or nonrecurring**. Autonomous entity adjustments are adjustments necessary to reflect the operations and financial position of the registrant as an autonomous entity when the registrant was previously part of another entity. Both transaction accounting adjustments and autonomous entity adjustments are required adjustments. In contrast, management's adjustments are optional adjustments that are not currently permitted, so the amendment provides registrants with the flexibility to include forward-looking information that depicts the synergies and dis-synergies of the transaction identified by management and to provide insight to investors as to the potential effects of the transaction and post-transaction plans expected to be taken by management. In response to various comments, the SEC modified the final amendment to permit the optional presentation of management's adjustments only if, in management's opinion, they would enhance an understanding of the pro forma effects of the transaction and certain conditions related to the basis and the form of presentation are met. The final amendments also include an instruction indicating that any forward-looking information is covered by the safe harbor provisions under Rule 175 under the Securities Act of 1933 and Rule 3b-6 under the Securities Exchange Act of 1934.
- *Foreign Businesses*. The adopted amendments permit Rule 3-05 Financial Statements to be prepared in a accordance with IFRS-IASB without reconciliation to U.S. GAAP if the acquired business would qualify to use IFRS-IASB if it were a registrant. The amendments also permit foreign private issuers ("FPIs") that prepare their financial statements using IFRS-IASB to provide Rule 3-05 Financial Statements prepared using home country GAAP to be reconciled to IFRS-IASB rather than U.S. GAAP. Additionally, the amendments permit an acquired business that would qualify as a FPI if it were a registrant to reconcile to IFRS-IASB rather than U.S. GAAP when the registrant is a FPI that uses IFRS-IASB.

[8] In this regard, it is worth noting that the SEC specifically declined to address "carve-out financial statements," in which financial statements of an acquired business are derived from the financial statements of a larger parent company and include allocations of the parent company's corporate overhead expenses, as the allocation process may require unique judgments that it believes should be addressed through consultation with the SEC staff.

- *Real Estate Operations*. The amendments align Rule 3-14—Financial Statements of Real Estate Operations Acquired or to be Acquired with Rule 3-05, where no unique industry considerations exist.
- *Amendments to Financial Disclosure Requirements for Investment Company Acquisitions*. The final rules add a definition of significant subsidiary in Regulation S-X tailored for investment companies, including business development companies, and a new Rule 6-11 of Regulation S-X, which would specifically cover financial reporting in the event of a fund acquisition and is modeled after amended Rules 3-05 and 3-14. The amendments also eliminate the requirement to provide pro forma financial information for investment company registrants in connection with fund acquisitions and to require supplemental financial information in its place.

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