

Memorandum

SEC Proposes Welcome Changes to Required Disclosures for Acquisitions and Dispositions

July 25, 2019

On May 3, 2019, the Securities and Exchange Commission proposed changes to the financial disclosure requirements relating to the acquisition and disposition of businesses.¹ 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 either the investment, asset or income test 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 otherwise be material or requiring older financial statements of an acquired business that are less likely to be material to an investor’s understanding of the combined business.

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 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 of similar fact patterns.

The proposed amendments are intended to improve financial information about acquired or disposed businesses, facilitate more timely access to capital and reduce the complexity and costs to prepare the required disclosures. The following is a summary of some of the proposed changes.

Proposed Changes 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 proposed amendments revise the test to compare the registrant’s investments in and advances to the acquired

¹ See [Amendments to Financial Disclosures About Acquired and Disposed Businesses](#), Release No. 33-10635; 34-85765; IC-33465, File No. S7-05-19 (May 3, 2019).

business (which includes the fair value of contingent consideration in certain circumstances) to the **“aggregate worldwide market value” of the registrant’s voting and non-voting common equity as of the last business day of the registrant’s most recently completed fiscal year.**² If the registrant does not have an aggregate worldwide market value, the existing test is applied.

- *Income Test.* Under the current test, the registrant’s equity in the acquired business’s income from continuing operations before taxes is compared to that of the registrant. This can produce counter-intuitive results for registrants whose earnings are closer to breakeven. The **proposed amendments add a new revenue component and simplify the calculation of the net income component by using income or loss from continuing operations after income taxes.** The proposed revenue component would compare the registrant’s and its other subsidiaries’ proportionate share of the acquired business’s consolidated total revenues to the registrant’s consolidated total revenues for the most recently completed fiscal year. Significance would be met only if the registrant exceeds *both* the revenue and net income components. The registrant 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 SX (“Rule 3-05 Financial Statements”) would be required. In cases where either the registrant or the acquired business does not have recurring annual revenue, only the net income component will be utilized.
- *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 proposed 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.
- *Dispositions.* The proposed 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 conforms the tests used to determine significance of a disposed business.

² 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.

Proposed Changes to Required Audited Financial Statements for Significant Acquisitions

- *Maximum of Two Years of Historical Financial Statements.* The proposed amendments eliminate the requirement to file the third year 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 statements of the acquired business for the “most recent” interim period specified in Rule 3-01 and 3-02 of Regulation S-X.** This proposal eliminates the need to provide comparative interim period financial information 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 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 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 filed³ 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 proposal removes these two exceptions and therefore the requirement to include Rule 3-05 Financial Statements in registration statements and proxy statements once the acquired business is reflected in filed post-acquisition registrant financial statements for a complete fiscal year.**
- *Modified Disclosure for Individually Insignificant Acquisitions.* Similar to the current rules, the proposed rules require disclosure if the aggregate impact of individually insignificant businesses acquired, or to be acquired, since the most recent audited balance sheet together with any acquired businesses which are significant but for which the financial statements have not yet been filed because of the 75-day grace period, exceeds 50%. Registrants would still be required to provide pro forma financial information depicting the aggregate effects of the acquisition of all such businesses **but would only have to provide historical financial statements for those targets that individually exceed the 20% significance level but are not yet required to file financial statements.**

³ 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.

Other Proposed Amendments

- *Simplified Pro Forma Adjustment Criteria.* Currently, registrants must file pro forma historical annual and interim income statements and the most recent balance sheet of the registrant and the acquired business, in the case of acquisitions, adjusted for certain items to show how the acquisition or disposition might have effected those financial statements. The 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. The pro forma condensed balance sheet can only be adjusted for items that are directly attributable to the transaction and factually supportable. **The proposed adjustments simplify the adjustments to reflect just “transaction accounting adjustments” and “management’s adjustments.”** The former includes the adjustments required to reflect the accounting for the acquisition, disposition or other transaction under GAAP, regardless of whether the impact is expected to be continuing or nonrecurring. The latter category includes forward-looking information that depicts the synergies, cost-savings and other transaction effects identified by management which will allow for more flexibility and adjustments that are not currently permitted. The proposal also includes presentation requirements and other disclosure requirements relating to each management’s adjustment which will provide further insight into the potential effects of the acquisition and the post-acquisition plans of management.
- *Foreign Businesses.* The proposed amendments permit Rule 3-05 Financial Statements to be prepared in 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 and permits 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.
- *Real Estate Operations.* The proposed 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 proposal adds a definition of significant subsidiary in Regulations S-X tailored for investment 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 proposed Rules 3-05 and 3-14.

For further information regarding this memorandum, please contact one of the following or any member of the Firm's Capital Markets Practice.

WASHINGTON, D.C.

William R. Golden
+1-202-636-5526
wgolden@stblaw.com

HOUSTON

Brian E. Rosenzweig
+1-713-821-5674
brosenzweig@stblaw.com

NEW YORK CITY

Bradley P. Goldberg
+1-212-455-2064
bgoldberg@stblaw.com

PALO ALTO

Daniel N. Webb
+1-650-251-5095
dwebb@stblaw.com

Edgar J. Lewandowski
+1-212-455-7614
elewandowski@stblaw.com

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UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Houston
600 Travis Street, Suite 5400
Houston, TX 77002
+1-713-821-5650

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2475 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
900 G Street, NW
Washington, D.C. 20001
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3901 China World Tower A
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Tokyo
Ark Hills Sengokuyama Mori Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino
Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000