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May 2019

SEC Proposes Changes to the Financial Statement Requirements Relating to Acquisitions and Dispositions of Businesses

On May 3, 2019, the Securities and Exchange Commission (SEC) proposed amendments to the financial disclosure requirements in Rule 3-05 (Acquired Company Financial Information), Rule 3-14 (Real Estate Operations), and Article 11 (Pro Forma Financial Information) of Regulation S-X for financial statements of businesses acquired or to be acquired and for business dispositions. The SEC also proposed new Rule 6-11 of Regulation S-X and amendments to Form N-14 for financial reporting of acquisitions involving investment companies, as well as additional changes related to oil and gas producing activities and real estate operations, and conforming changes for smaller reporting companies, which are not discussed in this GT Alert. The proposed changes are a continuation of the SEC's ongoing, comprehensive evaluation as part of its Disclosure Effectiveness Initiative.

The proposed changes are intended to (1) improve the financial information about acquired and disposed businesses; (2) facilitate more timely access to capital; and (3) reduce the complexity and cost to prepare the disclosure.

Overview of Current Financial Statement Requirements

When an issuer acquires a "business"[1], other than a real estate operation, Rule 3-05 of Regulation S-X generally requires an issuer to provide separate audited annual and unaudited interim pre-acquisition financial statements of the acquired business if it is significant to the issuer. The financial statements of the acquired business are generally the same as those as if the acquired business were a registrant, except that the number of years of audited financial statements is determined by the level of significance. Recognizing that certain acquisitions have a greater impact on the issuer than others, the SEC addresses the reporting requirements for businesses acquired or to be acquired based on the "significant subsidiary" definition in Rule 1-02(w) of Regulation S-X using a sliding scale approach.

Significance of an acquired business is evaluated under Rule 3-05 based upon three criteria (which in turn are derived from Rule 1-02(w)):

- the amount of the issuer's investment in the acquired business compared to the issuer's total assets (**Investment Test**);
- the issuer's share of the total assets of the acquired business compared to the issuer's total assets (**Asset Test**); and
- the issuer's share of pre-tax income from continuing operations of the acquired business compared to the issuer's pre-tax income from continuing operations (**Income Test**);

in each case, based upon a comparison between the issuer and acquired business's most recent annual financial statements.

Depending on the size of the acquisition and its significance to the issuer (based upon the tests noted above), audited acquired business annual financial statements for the most recent one, two, or three fiscal years must be included, plus appropriate unaudited interim financial statements. The following table summarizes the general rules for the financial statements required in connection with an acquisition.

Current Significance Criteria for Acquisitions	
Size of Acquisition	**Financial Statement Requirements**
Individual acquisition is at or less than 20% of any of the three significance criteria	No financial statements required.
Acquired business exceeds 20%, but not 40%, of any of the three significance criteria	One year of audited financial statements and the latest required interim period (unaudited) that precedes the acquisition, and the corresponding interim period of the preceding year.

[1] Defined in Rule 11-01(d) of Regulation S-X. The SEC staff's analysis of whether an acquisition constitutes the acquisition of a business, rather than of assets, focuses primarily on whether the nature of the revenue-producing activity previously associated with the acquired assets will remain generally the same after the acquisition. *See SEC, Division of Corporation Finance's Financial Reporting Manual, Note to Section 2010.2 "Determination of a Business."*

Acquired business exceeds 40%, but not 50%, of any of the three significance criteria	Two years of audited financial statements and the latest required interim period (unaudited) that precedes the acquisition, and the corresponding interim period of the preceding year.
Multiple acquisitions of unrelated businesses below the 20% significance level individually, but aggregating in excess of the 50% level of significance[2]	Audited financial statements covering at least the substantial majority of the businesses acquired and the latest required interim period (unaudited) that precedes the acquisition, and the corresponding interim period of the preceding year.
Acquired business exceeds 50%	Three years of audited financial statements and the latest required interim period (unaudited) that precedes the acquisition, and the corresponding interim period of the preceding year, unless net revenues of the acquired business were less than $100 million in its most recent fiscal year.

In addition, where a material acquisition has occurred or is probable, pro forma financial information complying with Article 11 of Regulation S-X for the most recent fiscal year and the most recent interim period will generally also be required. Pro forma financial information typically includes a pro forma balance sheet as of the end of the most recent period for which a consolidated balance sheet of the issuer is required and pro forma income statements for the issuer's most recent fiscal year and for the period from the most recent fiscal year end to the most recent interim date for which a balance sheet is required. The pro forma financial information is based on the historical financial statements of the issuer and the acquired or disposed business, and generally includes adjustments intended to show how the acquisition or disposition might have affected those financial statements had the transaction occurred at an earlier time.

Summary of Proposed Changes

The following is a summary of the proposed changes that are more frequently encountered by issuers.

Update to the Significance Tests

Investment Test

The SEC's proposal revises the Investment Test to compare the issuer's investment in the acquired business to the issuer's aggregate worldwide market value of its common stock (rather than total assets). If the issuer does not have an aggregate worldwide market value, then the existing Investment Test using total assets would be used. The SEC believes that using the issuer's aggregate worldwide market value would align the Investment Test more closely with the economic significance of the acquisition to the issuer.

[2] The requirement under Rule 3-05 to file financial statements of individually insignificant businesses under certain circumstances is applicable only to registration statements and proxies. Form 8-K does not require audited financial statements of insignificant businesses unless they are "related businesses" and significant on a combined basis.

The aggregate worldwide market value of the issuer would be determined as of the last business day of the issuer's most recently completed fiscal year, which for acquisitions and dispositions, will be at or prior to the date of acquisition or disposition. The proposal provides further instructions on an issuer's "investments in" the acquired business for acquisitions and dispositions, and clarifies the applicability of the Investment Test to combinations between entities under common control.

Income Test

The SEC's proposal revises the Income Test by adding a new revenue component and simplifies the calculation of the net income component by using income or loss from continuing operations after income taxes. This revised calculation will permit an issuer to use line item disclosure from its financial statements, simplifying the determination. The proposed revenue component would compare the issuer's proportionate share of the acquired business's consolidated total revenues (after intercompany elimination) to such consolidated total revenues for the issuer's most recently completed fiscal year. The SEC believes that revenue is an important indicator of the operations of a business and generally has less variability than net income. For issuers with marginal or break-even net income or net loss, the use of a net income component by itself can have the effect of requiring financial statements for acquisitions that otherwise would not be considered material to investors.

In addition, the Income Test would require that:

- where the issuer and the acquired business have recurring annual revenue, the acquired business must meet both the new revenue component and the net income component. In this case, the issuer would use the lower of the revenue component and the net income component to determine the number of periods for which financial statements are required.
- where the issuer or the acquired business does not have recurring annual revenues, only the net income component would apply.

The SEC's proposal also clarifies the net income component by inserting a reference to the absolute value of equity in the acquired business's consolidated income or loss from continuing operations. The SEC believes this clarification will mitigate the potential for misinterpretation that may result from inclusion of a negative amount in the computation.

Asset Test

The SEC's proposal leaves the asset test substantially unchanged.

Eliminate the Requirement to File Three Years of the Acquired Business's Financial Statements for an Acquisition that Exceeds 50% Significance

The SEC's proposal revises Rule 3-05 to require no more than two years of financial statements, depending on relative significance. Unlike the historical financial statements of the issuer upon which investors rely to make investment decisions about the issuer, the acquired business's financial statements are used, along with pro forma financial information, to discern how the acquired business may affect the issuer. The SEC believes two years of pre-acquisition financial statements would be sufficient to allow investors to understand the possible effects of the acquired business on the issuer.[3]

The proposal also revises Rule 3-05 for acquisitions where a significance test exceeds 20%, but none of the tests exceeds 40%, to require financial statements for the "most recent" interim period specified in Rule 3-01 and 3-02 rather than "any" interim period. This proposed revision would eliminate the need to provide a comparative interim period when only one year of audited financial statements is required.

Permit Disclosure of Financial Statements That Omit Certain Expenses for Carve-Out Transactions

Issuers frequently acquire a component of an entity[4] that may not have separate financial statements or maintain separate and distinct accounts necessary to prepare financial statements because they often represent only a small portion of the selling entity. In these circumstances, making relevant allocations of the selling entity's corporate overhead, interest, and income tax expenses may be impracticable.

The SEC's proposal would permit issuers to provide audited financial statements of assets acquired and liabilities assumed, and statements of revenues and expenses (exclusive of corporate overhead, interest, and income tax expenses) if:

- the business constitutes less than substantially all of the assets and liabilities of the seller and was not a separate entity, subsidiary, segment, or division during the periods for which the acquired business's financial statements would be required;
- separate financial statements for the business have not previously been prepared;
- the seller has not maintained the distinct and separate accounts necessary to present financial statements that include the omitted expenses, and it is impracticable to prepare such financial statements;
- interest expense may only be excluded from the statements if the debt to which the interest expense relates will not be assumed by the issuer or its subsidiaries consolidated;
- the statements of revenues and expenses do not omit selling, distribution, marketing, general and administrative, and research and development expenses incurred by or on behalf of the acquired business during the periods to be presented; and
- the notes to the financial statements include certain additional disclosures related to: the type of omitted expenses and the reasons why they are excluded from the financial statements; information about the business's operating, investing, and financing cash flows, to the extent available; an explanation of the impracticability of preparing financial statements that include the omitted expenses; and a description of how the financial statements presented are not indicative of the financial condition or results of operations of the acquired business going forward because of the omitted expenses.

[3] Nevertheless, regardless of the number of years presented, Rule 4-01(a) of Regulation S-X requires an issuer to 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" if trends depicted in the financial statements of the acquired business are not indicative or are otherwise incomplete.
[4] Such as a product line or a line of business contained in more than one subsidiary of the selling entity that is a business as defined in Rule 11-01(d), but does not constitute a separate entity, subsidiary, or division.

The SEC believes permitting issuers to provide abbreviated financial statements as proposed, while requiring the proposed additional disclosures, appropriately balances the cost of preparing financial disclosure with the protection of investors.

Clarify When Financial Statements and Pro Forma Financial Information are Required

The SEC's proposal would specify that financial statements are required if a business acquisition has occurred during the most recent fiscal year or subsequent interim period for which a balance sheet is required by Rule 3-01 of Regulation S-X, or if a business acquisition has occurred or is probable after the date that the most recent balance sheet has been filed. The proposal also clarifies that Rule 3-05 applies when the fair value option is used in lieu of the equity method to account for an acquisition because the disclosure required by U.S. GAAP on a post-acquisition basis and related requirements in Rules 4-08(g) and 3-09 include summarized financial information or separate financial statements of the business after the acquisition.

In addition, the proposal would replace the term "furnish" with "file" throughout Rule 3-05 and Article 11 to make clear that the information required by Rule 3-05 and Article 11 must be filed with the SEC.[5]

Consistent with current practice, the proposal would further provide that an issuer may continue to determine significance using amounts reported in its Form 10-K for the most recent fiscal year when the issuer has filed its Form 10-K after the acquisition consummation date, but before the date the issuer is required to file financial statements of the acquired business on Form 8-K. The SEC specifically noted that they propose to permit rather than require use of the more recent Form 10-K in this circumstance to avoid creating an incentive for issuers to delay filing their Form 10-K.

Permit the Use in Certain Circumstances of, or Reconciliation to, IFRS

The SEC's proposal modifies Rule 3-05 to permit the financial statements to be prepared in accordance with International Financial Reporting Standards (IFRS) without reconciliation to U.S. GAAP if the acquired business would qualify to use IFRS if it were an issuer, and to permit foreign private issuers that prepare their financial statements using IFRS to provide financial statements prepared using home-country GAAP to be reconciled to IFRS rather than U.S. GAAP.

No Longer Require Separate Financial Statements Once Acquired Business Included in Issuer's Post-Acquisition Financial Statements for a Full Fiscal Year

Rule 3-05(b)(4)(iii) currently permits the financial statements to be omitted once the operating results of the acquired business have been reflected in the audited consolidated financial statements of the issuer for a complete fiscal year. However, the financial statements are required to be included when they have not been previously filed[6] or when the financial statements have been previously filed, but the acquired business is of major significance[7] to the issuer.

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[5] At the time the SEC adopted Rule 3-05, there was no distinction between "furnished" and "filed." As Securities Act and Exchange Act rules subsequently began to converge, with documents filed pursuant to the Exchange Act having exposure to Securities Act liability, some disclosure was required or permitted to be furnished but "not filed" for certain purposes.
[6] This issue arises most often for initial registration statements under the Securities Act, such as an A/B Exchange Offer, and the Exchange Act because an existing Exchange Act reporting company would generally have been required to file Rule 3-05 financial statements on a Form 8-K within approximately 75 days after acquisition of a significant business.
[7] Rule 3-05 provides as an example that an acquired business that met at least one of the significance tests at the 80% level at the date of the acquisition would require the issuer to continue to file the financial statements of the acquired business for such periods prior to the purchase as may be necessary when added to the time for which audited income statements after the purchase are filed to cover the equivalent of the period specified in Rule 3-02.

The SEC's proposal would no longer require such financial statements in registration statements and proxy statements once the acquired business is reflected in filed post-acquisition issuer financial statements for a complete fiscal year. The SEC believes inclusion of post-acquisition results in the issuer's audited financial statements for a complete fiscal year should generally provide investors with sufficient information to make informed investment decisions about the issuer.

Use of Pro Forma Financial Information to Measure Significance

The SEC's proposal would expand the circumstances in which an issuer can use pro forma financial information for significance testing. Specifically, the proposal would permit issuers to measure significance using filed pro forma financial information that only depicts significant business acquisitions and dispositions consummated after the latest fiscal year-end for which the issuer's financial statements are required to be filed, subject to the following conditions:

- the issuer has filed Rule 3-05 financial statements for any such acquired business; and
- the issuer has filed the pro forma financial information required by Article 11 for any such acquired or disposed business.

The proposed changes would add a reference to Rule 11-02 to clarify that issuers may not include Management's Adjustments (see discussion below) when using pro forma financial information to determine significance. Rather, the pro forma financial information must be limited to the applicable subtotals that combine the historical financial information of the issuer and the acquired business and Transaction Accounting Adjustments (see discussion below).

The SEC believes these changes would provide issuers with the flexibility to more accurately determine the relative significance of an acquired or disposed business to the ongoing operations of the issuer without inadvertently delaying or accelerating the filing of pro forma financial information that might occur if the SEC required use of such pro forma financial information to determine significance.

Disclosure Requirements for Individually Insignificant Acquisitions

The SEC's proposal would, similar to existing requirements, require disclosure if the aggregate impact of businesses acquired or to be acquired since the date of the most recent audited balance sheet filed for the issuer, for which financial statements are either not required or are not yet required, exceeds 50%. The proposed rule, however, would require issuers to provide pro forma financial information depicting the aggregate effects of all such businesses in all material respects and pre-acquisition historical financial statements only for those businesses whose individual significance exceeds 20% but are not yet required to file financial statements. The SEC believes the proposed amendments would both improve the information provided to investors and reduce burdens on issuers of providing audited historical financial statements for immaterial acquisitions.

Improve the Content and Relevance of the Pro Forma Financial Information

Pro forma financial information generally shows the impact of the transaction on income from continuing operations of the issuer. Article 11 provides that the only adjustments appropriate in the presentation of the pro forma condensed statement of comprehensive income are those that are:

- directly attributable to the transaction,
- expected to have a continuing impact on the issuer, and

- factually supportable.

The SEC's proposal would revise Article 11 by replacing the existing pro forma adjustment criteria with simplified requirements to depict (1) the accounting for the transaction and (2) present the reasonably estimable synergies and other transaction effects that have occurred or are reasonably expected to occur. In the SEC's view, the existing pro forma adjustment criteria are neither clearly defined nor easily applied and, in practice, can yield inconsistent presentations for similar fact patterns. The existing adjustments also preclude the inclusion of adjustments for the potential effects of post-acquisition actions expected to be taken by management, which can be important to investors.

The proposed adjustments would be divided into two categories: (1) Transaction Accounting Adjustments and (2) Management's Adjustments.

Transaction Accounting Adjustments

Transaction Accounting Adjustments would depict (1) in the pro forma condensed balance sheet, the accounting for the transaction required by U.S. GAAP or IFRS, and (2) in the pro forma condensed income statements, the effects of those pro forma balance sheet adjustments, assuming the adjustments were made as of the beginning of the fiscal year presented. The Transaction Accounting Adjustments are intended to reflect only the application of required accounting to the acquisition, disposition, or other transaction.

Management's Adjustments

Management's Adjustments would be required for and limited to synergies and other effects of the transaction, such as closing facilities, discontinuing product lines, terminating employees, and executing new or modifying existing agreements, that are both reasonably estimable and have occurred or are reasonably expected to occur. The SEC believes it is appropriate to require disclosure of synergies and other transaction effects in these circumstances to provide investors insight into the potential effects of the acquisition and the post-acquisition plans expected to be taken by management.

Limiting Management's Adjustments to those that are reasonably estimable and that have occurred or are reasonably expected to occur will help limit the effects subject to inclusion in pro forma financial information. The proposal would also require issuers to additionally provide qualitative disclosure of such information in the explanatory notes to the pro forma financial information to further elicit appropriately balanced disclosure.

Presentation Requirements

The SEC's proposal would include presentation requirements for Management's Adjustments. The presentation requirements would provide that Management's Adjustments be presented through a separate column in the pro forma financial information after the presentation of the combined historical statements and Transaction Accounting Adjustments.

In addition, to clarify the required disclosure in the explanatory notes accompanying the pro forma financial information, the SEC proposes to add requirements that would require disclosure of:

- revenues, expenses, gains and losses, and related tax effects which will not recur in the income of the issuer beyond 12 months after the transaction;

- total consideration transferred or received, including its components and how they were measured[8]; and
- information about Transaction Accounting Adjustments when the initial accounting is incomplete.

For each Management's Adjustment, the SEC's proposal would require:

- a description, including the material uncertainties, of the synergy or other transaction effects;
- disclosure of the underlying material assumptions, the method of calculation, and the estimated time frame for completion;
- qualitative information necessary to give a fair and balanced presentation of the pro forma financial information; and
- to the extent known, the reportable segments, products, services, and processes involved; the material resources required, if any; and the anticipated timing.

The SEC believes these disclosures are necessary for an investor to be able to understand the Management's Adjustments.

Significance Tests and Business Dispositions

The SEC's proposal would revise Rule 11-01(b) to raise the significance threshold for the disposition of a business from 10% to 20%, to conform to the threshold at which an acquired business is significant under Rule 3-05. The SEC believes that having the same threshold and tests for the disposition of a business would simplify compliance for issuers. The SEC further notes that it sees no compelling reason why the subset of businesses for which investors need information should differ depending on whether the business is being acquired or disposed.

Additional Thoughts

The proposal is subject to a 60-day public comment period following its publication in the Federal Register.

Although the SEC considered comments received from its 2015 request for comment for certain financial disclosure requirements in Regulation S-X, based upon Commissioner Jackson's statement relating to the rule proposal, it appears the SEC still has reservations about some of the proposed changes, including substitution of the issuer's aggregate worldwide market value for the issuer's total assets in the Investment Test for significance.

The proposed changes to the significance tests will affect other disclosures, including the identification of significant subsidiaries listed in exhibit 21 to an issuer's Form 10-K, as well as certain representations and warranties referenced in various purchase agreements covering significant subsidiaries.

[8] If total consideration includes contingent consideration, the proposed amendments would require disclosure of the arrangement(s), the basis for determining the amount of payment(s) or receipt(s), and an estimate of the range of outcomes (undiscounted) or, if a range cannot be estimated, that fact and the reasons why.

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