June 3, 2020

SEC Adopts Significant Changes to the Financial Disclosure Requirements for Acquisitions and Dispositions of Businesses

On May 21, 2020, the SEC adopted final amendments to the rules governing the required financial information for business acquisitions and dispositions. As amended, the rules should reduce the circumstances in which audited financial statements of acquired businesses are required and will reduce the required number of years presented. The final rules are effective for fiscal years beginning after December 31, 2020, but voluntary early compliance is permitted. This Alert highlights the more significant aspects of the final rules.

Significance Tests for Acquisitions

Registrants are required to provide audited financial statements of an acquired business based on its significance to the registrant. Significance is measured using three tests: asset, investment and income. Under the new rules, the tests are applied as follows:

- *Asset test* – This test remains the same and measures the total assets of the business acquired against the consolidated total assets of the registrant.
- *Investment test* – This test has been amended to compare the registrant's investment in the business (typically the consideration to be paid) with the registrant's aggregate worldwide market value of voting and non-voting common equity (instead of the book value of the registrant's total assets). Total assets will still be used if the registrant's equity is not publicly traded. This amendment is expressly limited to acquisitions and dispositions; the SEC has retained the current test for other significant subsidiary determinations.
- *Income test* – Although the SEC had proposed to change this test to measure "net income" rather than pre-tax income, it reversed course and retained the use of pre-tax income in the final rules. In addition, however, the SEC added a revenue component, comparing the revenue of the acquired business to that of the registrant, unless either did not have material revenue in each of the last two fiscal years. Significance would be met under the revised income test only if the registrant exceeds both components. The registrant would then use the lower of the two components to determine the number of periods for which financial statements would be required.

Periods Presented

If none of the above conditions exceeds 20%, financial statements of the acquired business are not required. Otherwise:

- If any of the conditions exceeds 20% but none exceeds 40%, financial statements for the most recent fiscal year and the most recent interim period (if any) are required.
- If any of the conditions exceeds 40%, financial statements for the two most recent fiscal years and interim periods (if any) are required.

Gone is the former requirement to provide three years of audited financial statements when any of the significance tests exceed 50%.

Abbreviated Financial Statements

The final rules add S-X Rule 3-05(e) to address financial statement requirements for an acquisition of net assets that constitutes a business that is significant to the registrant but that was not a separate entity, segment or division and for which separate financial statements were not prepared and would be impracticable to prepare. In these circumstances, a registrant may present a statement of assets acquired and liabilities assumed, a statement of comprehensive income that includes expenses incurred but may omit corporate overhead, interest expense of debt not assumed and income tax expense. Financial statement notes would provide explanations along with information about cash flows to the extent available.

This accommodation applies only if certain qualifying conditions are satisfied, including where the total assets and total revenues of the acquired or to be acquired business constitute 20% or less of the corresponding amounts for the seller – in other words, a business that is not significant to the seller.

Dispositions

The final rules raise the significance threshold from 10% to 20% for dispositions of a business for which pro forma financial information of the registrant would be required, thus aligning the rules for dispositions with those for acquisitions.

Registration Statements and Proxy Statements

The final rules permit the omission of pre-acquisition financial statements from registration statements and proxy statements (1) for businesses that exceed 20% but do not exceed 40% significance once they are included in filed audited post-acquisition results for nine months and (2) for businesses that exceed 40% significance once they are included in filed audited post-acquisition results for a complete fiscal year. In addition, the final rules eliminate the requirement that separate acquired business financial statements be provided when they have not been previously filed or when they have been previously filed but the acquired business is of major significance.

Individually Insignificant Businesses

Acquisitions that are individually insignificant but that exceed 50% significance in the aggregate will no longer require separate audited financial statements for a substantial majority of the acquired businesses. Instead, under the final rules, the acquirer will need to provide pro forma financial information showing the material aggregate effects of all such individually insignificant businesses. In measuring significance under the income test, acquired businesses with profits must be aggregated separately from those reporting losses, and, if either group exceeds 50% significance, the disclosure requirements apply to all of the acquired businesses.

Pro Forma Financial Information

Currently, registrants required to present pro forma financial information under Article 11 of Regulation S-X about an acquisition or a disposition make adjustments that reflect transaction accounting as well as events directly attributable to the transaction that are expected to have a continuing impact on results and are factually supportable. The SEC also had proposed to require management adjustments for expected synergies. That proposal drew substantial comment, and the SEC dropped it in the final rules. In the final rules, pro forma financial information must include transaction accounting adjustments under U.S. GAAP or IFRS and autonomous entity adjustments that apply in a spin-off. In addition, the final rules permit, but do not require, registrants to include management adjustments that have a reasonable basis and are necessary for a fair presentation.

Other Changes

The final rules make corresponding changes to S-X Rule 3-14 relating to acquired real estate operations to align with Rule 3-05.

For acquisitions of foreign businesses, the final rules provide greater flexibility to provide financial statements using either IFRS without reconciling to U.S. GAAP or using home-country GAAP reconciled to IFRS, rather than U.S. GAAP.

Separate rules apply to smaller reporting companies and Regulation A issuers. These rules were amended to conform to the changes to S-X Rule 3-05 and Article 11.

The final rules also include certain changes tailored to the financial reporting requirements for investment companies and business development companies, including new rules to cover the financial reporting of fund acquisitions.

Key Takeaways

The changes to the investment and income tests should help reduce the “false positives” that the former tests frequently delivered and thus reduce the need to seek waivers of the requirements under S-X Rule 3-13. Because the significance tests likely disproportionately affect small- and mid-sized companies, the regulatory relief should be most welcome.

With respect to the new pro forma financial requirements applied to individually insignificant acquisitions, the SEC acknowledged concerns as to whether accountants will be able to provide negative assurance “comfort” to underwriters on the combined pro forma financial information, if historical financial statements included in the pro forma financial information for individually insignificant acquisitions have not been reviewed or audited. Audit firms, underwriters and their counsel will need to evaluate how to address these issues.

For pro forma adjustments, the decision to make management adjustments optional rather than mandatory was a salutary one. However, if management desires to include any adjustments, all adjustments that are necessary for a fair presentation must be included. Registrants may elect to forego providing any management adjustments rather than opening up the pro formas to comments from the SEC staff seeking additional adjustments. That could result in less useful pro forma financial information.

Registrants will be able to rely on the new thresholds at any time following adoption of the new rules rather than waiting until the mandatory compliance date of January 1, 2021. We expect most registrants will choose early adoption, even with the associated obligation to apply all of the rules.

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If you would like to learn more about the issues in this Alert, please contact your usual Ropes & Gray attorney.