SEC Proposes Amendments to Rules on Financial Disclosures for Acquisitions and Dispositions

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On Friday, the SEC proposed extensive amendments to the rules governing financial disclosures by registrants about businesses they buy or sell. The proposed amendments primarily relate to disclosures required by Rule 3-05 and Article 11 of Regulation S-X in registration statements and 1934 Act reports, and, for the most part, they would reduce the burden of preparing historical financial statements and pro forma financial information. The proposal follows a broader 2015 concept release on financial disclosures about entities other than the registrant, and it represents another step by the SEC to reduce the burdens on registrants in a careful way that does not take away information that is material to investors.

The proposed amendments would affect the following elements of the rules applicable to typical corporate registrants.

- The calculation methods for determining whether an acquisition or disposition is significant
- The periods for which historical financial statements must be presented if an acquisition is determined to be significant
- For first-time registrants in particular, the need for target financial statements for significant acquisitions consummated in prior periods
- The requirements for historical financial statements of a target business carved out of a broader entity that did not maintain separate financial statements of the target
- The requirements for financial statements of foreign targets
- Adjustments in pro forma financial information for acquisitions
- Significance threshold for dispositions

The proposal includes additional changes specific to real estate companies, companies in the oil and gas industry, investment companies and companies that qualify as smaller reporting companies. We do not address these industry and category-specific proposals in this memo.
Determining Significance – Calculation Methods

Currently, the three alternative tests used to determine significance under Regulation S-X are based on:

1. the size of the registrant’s investment in the target as compared to the assets of the registrant,
2. pre-tax income of the target as compared to pre-tax income of the registrant, and
3. the assets of the target as compared to the assets of the registrant.

These tests sometimes have anomalous results, especially where a registrant’s pre-tax income changes from positive to negative or is unusually small in a given year.

The proposal would amend the investment and income tests as follows:

- **Investment test**: the proposal would change the investment test in two ways:
  - The denominator of the investment test, for a registrant with a measurable public float, would be changed from total assets of the registrant to the worldwide market value of the registrant. The worldwide market value would be determined as of the last business day of the registrant’s most recent fiscal year. The proposal does not provide for an alternative measurement period or date to take into account fluctuations in stock prices, which presumably are more frequent than fluctuations in total asset value (the denominator under current rules).
  - The numerator of the investment test would also be changed, to require the inclusion of the fair value of contingent consideration as part of the investment amount.

- **Income test**: the proposal would change the income test in three ways:
  - The income calculation would be amended to be based on after-tax income of both the registrant and the target, in lieu of the pre-tax income requirement in the existing test.
  - The test would not be met unless two different calculations both exceed the applicable minimum threshold: (i) target income divided by registrant income and (ii) target revenue divided by registrant revenue. The revenue component of the test, which is new, would not apply where either the registrant or the target does not have recurring revenue, and in that case only the income component would need to be met for an acquisition to be deemed significant. “Recurring” revenue is not defined in the proposal and we expect that commenters may ask the SEC to provide a definition.
  - A registrant with income for its last fiscal year that is 10% less than its five-year average income is currently permitted to use its five-year average income instead of the prior year income as the denominator for the income test. To calculate the average, the current rule requires the use of zero for any loss year in the five years. The new test would permit a registrant to use the absolute value of any loss in determining the average (which would result in a larger denominator and therefore a lower chance of tripping the significance threshold).

The proposed amendments would also permit a first-time registrant meeting certain requirements to use pro forma financial information to determine the denominator for either the net income test or the asset...
test if it has made acquisitions after its last fiscal year end. This proposed change reflects accommodations the staff has previously granted under Rule 3-13, for example to acquisitive IPO companies that have increased their total assets significantly through acquisitions since the date of their last fiscal year end.

**Periods to be Presented**

Currently, a registrant is required to provide audited historical financial statements of a target (a) for three years, if significance exceeds 50%, (b) for two years, if significance exceeds 40%, and (c) for one year, if significance exceeds 20%. Any subsequent interim period and the comparative period from the prior year must also be provided.

The proposal would eliminate the three-year requirement in all cases. Registrants would instead be required to present historical financial statements (a) for two years, if significance exceeds 40%, and (b) for one year, if significance exceeds 20%. The proposal would also maintain the requirement to present the subsequent interim period, but the corresponding interim period from the prior year would only be required if two years of financial statements are required.

**Financial Statements of Carved-out Businesses**

Often a target is significant to the registrant, but consists of a component of an entity, for which historical financial statements were never prepared. These situations typically require time and expense to prepare either the required financial statements or a request for relief from the SEC staff. The proposal acknowledges the burden on acquirors and targets in this context, and the amendments would permit more limited (but still audited) financial statements of the target business.

**Foreign Acquirors and Targets**

The test to determine whether a target is a “foreign business” – permitting historical financial statements required by S-X 3-05 to be presented in IFRS instead of US GAAP – is more stringent than the “foreign private issuer” definition. There are therefore cases under the current rules where a non-reporting target that would qualify as an FPI if it were a registrant does not qualify as a foreign business, because the FPI test permits some registrants with majority US ownership to qualify as FPIs, while the foreign business test requires majority ownership outside the US. Registrants have successfully sought relief from the SEC staff on this test in the past. The proposed amendments would eliminate the existing foreign business test and replace it with the foreign private issuer test.

The current rules also require a registrant acquiring a target that maintains financial statements under accounting principles other than US GAAP or IFRS to reconcile those financial statements to US GAAP. This results in noncomparable information where an FPI registrant with IFRS financial statements presents target financial statements reconciled to US GAAP. The proposed amendments would resolve this discrepancy by permitting financial statements of a target filed by an FPI registrant to be reconciled to IFRS as issued by the IASB.

**Inclusion of Financial Statements of Historical Targets**

The current rules require a registrant that made a significant acquisition in any year for which financial statements of the registrant are included in a filing to include the historical financial statements of the target (if not previously filed). In practice, this means a first-time registrant (for example, an IPO company) that has made one or more acquisitions before going public has to go back and obtain (or worse, create for the first time) stand-alone audited historical financial statements for those targets, even after the targets have been consolidated in its financial statements for more than a year. Separately, the current rules also require a registrant to include financial statements of targets of “major significance” (typically 80% or more under the S-X tests) in filings for post-acquisition periods no matter how long they have been consolidated. This often results in the inclusion of historical financial statements of a business that, now consolidated, may no longer be as significant to the registrant as it was at the time of the acquisition.
The proposed amendments would resolve these problems by eliminating both requirements and no longer requiring historical financial statements of any target once consolidated in the registrant’s financial statements for a complete fiscal year.

**Individually Insignificant but Related Acquisitions**

Under the current rules, if a registrant acquires unrelated businesses that do not individually meet the significance test but that together would exceed 50% significance, it must file historical audited financial statements (and related pro forma financial information) for those businesses constituting the majority of the group. For example, if 11 related targets each are 5% significant, financial statements for six of them must be filed and the pro formas will only reflect those six, which can produce an artificial picture of what the combined company will look like. Under the proposed rules, that registrant would only have to file historical audited financial statements for any business in the group that individually exceeds 20% significance, but it would have to include pro forma financial information reflecting the entire transaction.

**Acquisition Pro Formas**

Pro forma financial information is intended to reflect the impact of an acquisition on an ongoing basis, and the current rule permits adjustments if they are directly attributable to the transaction and factually supportable. In the income statement they must also be expected to have a continuing impact on the registrant. The release recognizes that these requirements are not particularly clear and can yield inconsistent presentation across transactions and registrants, although the new rule could prove as difficult to apply as the existing rule. The proposed rule would replace the existing adjustment requirements with two categories of adjustments, each required to be presented in a separate column as set forth below.

- **Transaction Accounting Adjustments**: to reflect the application of required accounting to the transaction.
- **Management Adjustments**: to reflect synergies and other effects of the transaction. These must be reasonably estimable and either existing or reasonably expected to occur. Qualitative disclosure would separately be required in the notes to the pro forma financial information where quantification is not reasonably estimable.

An issue to consider in commenting on the proposal is whether requiring forward-looking information under the management adjustment prong would raise liability concerns, particularly where the forward-looking statements safe harbor would not be available.

**Significance Threshold – Dispositions**

Under the current rules, a registrant must file pro forma financial information for any disposition that exceeds the 10% significance threshold. The proposed amendments would increase the significance threshold for dispositions to 20% to match the threshold in the context of acquisitions. The changes to the significance tests described above would also apply to dispositions. Unlike in the case of a significant acquisition, however, where a registrant generally benefits from a 75-day post-closing grace period to file the required historical financial statements and pro forma financial information, a registrant must file pro forma financial information reflecting a disposition within four business days of closing. The proposed amendments would not change that timing.

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