ALERT MEMORANDUM

New SEC Rules on Financial Disclosures for Acquisitions and Dispositions

May 27, 2020

On May 21, 2020, the SEC adopted extensive amendments to the rules governing financial disclosures by registrants about businesses they acquire or dispose of.[1] The amendments were first proposed in May 2019 and have been adopted largely as they were proposed.[2] They primarily relate to disclosures required by Rule 3-05 and Article 11 of Regulation S-X in registration statements and periodic reports, and, for the most part, they reduce the burden of preparing historical financial statements and pro forma financial information.

These amendments are part of the Disclosure Effectiveness Initiative the SEC has been pursuing since 2013. (We are maintaining a tracker that summarizes the elements of that initiative.) One focus of the Disclosure Effectiveness Initiative, starting with a 2015 concept release, has been rules requiring a reporting company to provide financial information about some other entity – for example, a proposed acquisition, a recently acquired business, or a business that has been sold or otherwise disposed of. These rules can be particularly difficult to apply, and the new amendments make modest but welcome improvements. Although the changes are highly technical, in some circumstances they will affect how companies evaluate whether to proceed with financing in the public capital markets.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors

NEW YORK

Nicolas Grabar
+1 212 225 2414
ngrabar@cgsh.com

Katherine M. Clemens
+1 212 225 2321
kclemens@cgsh.com

Tom Kwon
+1 212 225 2394
yokwon@cgsh.com

[1] SEC Release No. 33-10786; 34-88914 (May 21, 2020), available at https://www.sec.gov/rules/final/2020/33-10786.pdf
[2] SEC Release No. 33-10635; 34-85765 (May 3, 2019), available at https://www.sec.gov/rules/proposed/2019/33-10635.pdf

clearygottlieb.com

© Cleary Gottlieb Steen & Hamilton LLP, 2020. All rights reserved.

This memorandum was prepared as a service to clients and other friends of Cleary Gottlieb to report on recent developments that may be of interest to them. The information in it is therefore general, and should not be considered or relied on as legal advice. Throughout this memorandum, "Cleary Gottlieb" and the "firm" refer to Cleary Gottlieb Steen & Hamilton LLP and its affiliated entities in certain jurisdictions, and the term "offices" includes offices of those affiliated entities.

For typical reporting companies, the amendments affect the following elements of the rules.

- 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 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 newly acquired business carved out of a broader entity that did not maintain separate financial statements for it
- The requirements for financial statements of foreign targets
- Adjustments in pro forma financial information for acquisitions
- The significance threshold for dispositions

The amended rules are effective January 1, 2021. Under the transition guidance in the adopting release, a registrant must comply with the new rules for new and amended registration statements, Item 2.01 8-Ks and periodic reports as of the first day of its first fiscal year beginning after December 31, 2020. A registrant may use the amended rules starting now, provided it complies with them in their entirety. However, an issuer that has already filed an Item 2.01 8-K but has not yet filed the required financial statements (in reliance on the grace period in Item 9.01) must comply with the prior rules.

The amendments include 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 specific elements of the new rules in this memo.

The amendments do not change the financial statement requirements applicable for an acquisition that is the subject of a proxy statement or a registration statement on Form S-4 or Form F-4.

Determining Significance – Calculation Methods

A number of SEC rules require a reporting company to determine whether some other entity – for example, a new acquisition, a subsidiary being sold, or an equity method investee – is "significant" to the reporting company. (For simplicity, this memo refers to the other entity as a "target," but acquisitions are only one circumstances in which these rules apply.)

There are three separate tests to determine significance, which are set forth in Rule 1-02(w) of Regulation S-X. They are (1) an investment test, which, under the existing rules, compares the size of the registrant's investments in and advances to the target to the assets of the registrant, (2) an income test, which, under the existing rules, compares pre-tax income of the target to pre-tax income of the registrant and (3) an asset test, which compares the assets of the target 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 new rules make a number of technical changes to the significance tests. The most important, relating to the investment and income tests, are described below.

- *Investment test*: for acquisitions and dispositions (other than between entities under common control), the amendments change the investment test in two principal ways:

    - They change the denominator. For acquisitions and dispositions, the denominator of the investment test is changed from the registrant's total assets to the *aggregate worldwide market value* of the registrant's voting and non-voting common equity, when available. The new rules require registrants to use the average of aggregate worldwide market value 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. In circumstances where the registrant does not have an aggregate worldwide market value, the denominator remains total assets as of the end of the most recently completed fiscal year.

  - o They add contingent consideration to the numerator. For acquisitions, the numerator of the investment test must now include the fair value of contingent consideration (if required to be recognized at fair value by the registrant for accounting purposes) as part of the investment amount. If contingent consideration is not required to be recognized at fair value by the registrant, the numerator of the investment test must include all contingent consideration (including sales-based milestones and royalties, which had been excluded under the original proposal), except contingent consideration for which the likelihood of payment is remote. For dispositions, all contingent consideration is included.

- *Income test*: the amendments change the income test in two principal ways:

  - o They add a revenue component to the income test. The income test is not met unless two different calculations both exceed the applicable threshold: (i) pre-tax income of the target divided by pre-tax income of the registrant and (ii) target revenue from continuing operations (after intercompany eliminations) divided by registrant revenue. The revenue component of the test does not apply where either the registrant or the target did not have material revenue in each of the two most recently completed fiscal years, and in that case only the income component needs to be met for an acquisition to be deemed significant.

  - o They moderate the effects of volatility in past results. 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 existing rule requires the use of zero for any loss year in the five years. The new test permits 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 new rules also permit a first-time registrant meeting certain requirements to use pro forma financial information for significance testing if it has made acquisitions after its last fiscal year end. This change reflects accommodations the staff has previously granted. Under these new rules, registrants are expected to have flexibility to more accurately determine the relative significance of an acquired or disposed business.

Periods to be Presented

Under the existing rules, 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 amended rules eliminate the requirement to present a third year. Registrants instead are required to

present historical financial statements (a) for two years, if significance exceeds 40%, and (b) for one year, if significance exceeds 20%. Under the new income test, registrants use the lower of the revenue component and the income component to determine the number of years to present. The new rules also maintain the requirement to present the subsequent interim period, but the corresponding interim period from the prior year is only required if two years of financial statements are required.

Financial Statements of Carved-out Businesses

Often a target consists of a component of an entity, for which historical financial statements were never prepared. These carve-out situations often require time and expense to prepare the required financial statements, unless relief can be obtained from the SEC staff. New paragraph (e) of Rule 3-05 permits a registrant to file abbreviated financial statements of the target if it meets certain qualifying conditions. The key qualifying condition is that the target represented 20% or less of the seller's consolidated assets and revenues.

Foreign Targets

The amendments address some complications that can arise when a target has historical financial statements that are prepared under IFRS, or under another home-country GAAP, rather than under U.S. GAAP. In particular, under the new rules:

- If the registrant is a foreign private issuer that reports under IFRS, and the target is a foreign business using home-country GAAP, the registrant may reconcile the target financial statements to IFRS. In the existing rules, this reconciliation must be to U.S. GAAP.

- If the target meets the definition of foreign private issuer, new Rule 3-05(d) allows the target financial statements to be presented under IFRS (without reconciliation to U.S. GAAP). This applies even if the registrant uses U.S. GAAP, but in that event any pro forma financial information must still be under U.S. GAAP.

The amendments retain the concept of a "foreign business" – a narrower category than "foreign private issuer" for which certain limited additional accommodations are available.

Inclusion of Financial Statements of Historical Targets

The existing 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 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 existing 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 that, now that the target is consolidated, may no longer be as useful as they were at the time of the acquisition.

The new rules resolve these problems by eliminating both requirements and no longer requiring historical financial statements of any target (including those deemed to be of "major significance" under the existing rules) once it is reflected in the registrant's post-acquisition financial statements for nine months or a complete fiscal year, depending on the significance of the target. The SEC did not prescribe any additional requirements to disclose information about the comparability of pre- and post-acquisition periods, but observed that other existing rules, such as Item 303 of Regulation S-K (MD&A) and Rule 4-01(a) of Regulation S-X, already require that disclosure to the extent material.

Individually Insignificant Acquisitions

The existing rules sometimes require audited historical financial statements to be filed for acquisitions even if they are individually insignificant. This can occur when, after the most recent audited balance sheet date, a registrant has acquired a combination of unrelated businesses that do not individually meet the significance test, or that are significant for which the required historical financial statements have not yet been filed (in reliance on the 74-day grace period), which together exceed 50% significance. In that case, the registrant must file one year of historical audited financial statements plus unaudited historical financial statements for the interim period and corresponding comparative period (and related pro forma financial information) for businesses constituting the majority of the group. For example, if 11 targets each are 5% significant, financial statements for at least six of them must be filed and the pro formas will only reflect those targets, which can produce an artificial picture of the combined company.

Under the new rules, the registrant must include pro forma financial information reflecting the aggregate effect of *all* of the acquisitions in all material respects. It does not need to include any separate historical financial information for individually insignificant acquisitions, although it is required to include at least one year and one interim period of historical financial statements for any consummated or probable acquisitions that are significant for which historical financial statements have not yet been filed. For purposes of the income test, businesses reporting losses are tested separately from businesses reporting income – if the result for either of the groups exceeds 50%, the income test is deemed met for both income- and loss-reporting businesses as a group.

While the new rules will reduce the audit requirements for insignificant acquisitions, if auditor negative assurance on the pro forma financial information is required, the auditors may need to perform additional review procedures on the financial statements of a larger number of insignificant acquisitions.

Acquisition Pro Formas

Pro forma financial information is intended to reflect the impact of an acquisition on an ongoing basis, and the existing 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 new rules replace the existing adjustment requirements with three categories of adjustments as set forth below.

- *Transaction Accounting Adjustments (required)*: to reflect the U.S. GAAP or IFRS accounting for the transaction.
- *Autonomous Entity Adjustments (required)*: to reflect the operations and financial position of the registrant as an autonomous entity when the registrant was previously part of another entity.
- *Management's Adjustments (optional)*: to reflect synergies and dis-synergies of the transaction as of the most recent practicable date. If these adjustments are included, there must be a reasonable basis for each adjustment, all adjustments necessary in management's judgment to a fair statement of the pro forma effects must be presented, and the adjustments must be limited to the effects as if the synergies and dis-synergies existed at the beginning of the period. Since these are optional disclosures, in order to enhance comparability, these adjustments must be presented in the explanatory notes to the pro forma financial information as a reconciliation to pro forma net income, and disclose the basis for and material limitations of each Management's Adjustment.

Management's Adjustments were arguably the most controversial part of the 2019 proposal, in which they would have been required disclosure. In response to commenters, the SEC made the Management's Adjustments optional, although the adopting release encourages registrants to include them if the conditions in the new rule are met. Any forward-

looking information supplied will be expressly covered by the safe harbors under Rule 175 under the Securities Act and Rule 3b-6 under the Exchange Act. Registrants may, however, hesitate to include Management's Adjustments, except in the context of a transaction where synergies are used in the marketing, given the forward-looking, potentially sensitive and uncertain nature of transaction synergies and dis-synergies and the potential need to update previously filed pro formas in future filings in order to show Management's Adjustments as of the most recent practicable date.

Significance Threshold – Dispositions of Businesses

Under the existing rules, a registrant must file pro forma financial information for any disposition of a business that exceeds the 10% significance threshold. The new rules increase the significance threshold for dispositions of businesses to 20%, to match the threshold in the context of acquisitions of businesses. The changes to the significance tests described above also apply to dispositions of businesses. 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 under Item 9.01 of Form 8-K, a registrant must file pro forma financial information reflecting a disposition within four business days of closing. The new rules do not change that timing, or change the Item 2.01 8-K trigger threshold for acquisitions or dispositions of assets.

…

CLEARY GOTTLIEB