Client Alert | Capital Markets

SEC Proposes Changes to Financial Disclosure Relating to Business Acquisitions and Dispositions

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Authors: Colin Diamond, Doron Loewinger, Michelle Rutta, Adrien Dumoulin-Smith, Nico Nalbantian, Danielle Herrick

On May 3, 2019, the Securities and Exchange Commission (the "SEC") proposed amendments to its rules governing disclosure of financial statements by public companies or in initial public offerings ("IPOs") in connection with certain significant business acquisitions and dispositions.[1] The proposed amendments, which are part of the SEC's ongoing disclosure effectiveness initiative, are intended to improve the information investors receive, facilitate more timely access to capital and reduce complexity and compliance costs.

Background and Summary of the Proposed Amendments

When a public company acquires or disposes of a business that is "significant", or such a transaction is probable, Regulation S-X requires certain disclosure with regard to the acquired or disposed business. For example, Rule 3-05 requires a filer to disclose separate audited annual and unaudited interim financial statements of a significant acquired business; Article 11 requires a filer to disclose pro forma balance sheet and income statements showing how a significant acquisition or disposition might have affected historical financial statements. The proposed amendments would modify these requirements by, among other things:

- Revising the tests used to determine the significance of an acquisition or disposition;
- Raising the "significance" threshold for dispositions from 10 percent to 20 percent;
- Reducing the number of audited and interim periods for which historical financial statements must be presented if an acquisition is determined to be significant;
- Expanding the use of, or reconciliation to, International Financial Reporting Standards as issued by the International Accounting Standards Board ("IFRS-IASB");
- Permitting abbreviated financial statements for acquisitions of a component of an entity;
- Eliminating the requirement to provide separate financial statements for an acquired business once it has been included in the acquirer's financial statements for a complete fiscal year; and
- Replacing existing criteria for adjustments in *pro forma* financial information with "Transaction Adjustments", reflecting application of required accounting to the transaction, and "Management's

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[1] The proposed amendments can be found here.

Adjustments", reflecting reasonably estimable transaction effects, such as synergies, that have occurred or are likely to result from the transaction.

Amendments to Significance Tests

Generally, the more significant the acquired business, the greater the disclosure required. Significance is measured by the SEC as a percentage on a sliding scale and is determined by applying three significance tests, the "Investment Test," the "Asset Test," and the "Income Test." An acquired business is significant if it exceeds a threshold under any one of the three tests, and the level of disclosure required increases as additional thresholds are passed. The proposed amendments would revise the calculation of significance under the Investment Test and the Income Test[2], and are intended to more accurately reflect the relative economic significance of the acquired business to the filer and reduce anomalous results when the test is applied.

Proposed Amendments to the Investment Test

Currently, the Investment Test compares the filer's investment in the acquired business (*i.e.*, the purchase price or the consideration transferred) to the filer's consolidated total assets. The proposed amendments would change the denominator of the Investment Test from total assets to the "aggregate worldwide market value" of the filer's common equity (*i.e.,* its total capitalization). The SEC believes this reflects the "fair value" of the filer more effectively than using total assets, which represents fair value for certain assets and historical cost for others, and is not reduced by the value of liabilities. If the filer does not have publicly traded common equity, the current investment test would continue to apply.

Proposed Amendments to the Income Test

Currently, the Income Test compares the acquired business' income from continuing operations before taxes with that of the filer. By focusing only on income, which can include non-recurring or infrequent expenses, gains or losses, this test can produce anomalous results.

To address this, the proposed amendments would split the Income Test into two components: (i) a revenue component and (ii) an income component.

The revenue component would compare the acquired business' revenue and the filer's revenue, providing some relief to filers with little net income or which are suffering losses. Where the filer and the acquired business have recurring annual revenues, the acquired business must meet both components, and the lower of the two components would be used to determine the level of significance. Where the filer or the acquired business do not have recurring annual revenues, then the income component would apply on its own. The income component would be amended to use income from continuing operations *after* taxes, which simplifies the calculation by allowing companies to use line items directly from their financial statements. Certain other adjustments to the calculation of income are proposed to simplify application of the test and make it more indicative of relative significance.

Proposed Amendments to the Disposition Threshold

The proposed amendments would also revise Rule 11-01(b) and Rule 1-02(w) to align the significance threshold applicable to dispositions with those applicable to acquisitions. Currently, financial statements are required if the disposed business exceeds 10 percent significance, rather than the 20 percent applicable to acquisitions. The proposed amendments would raise the threshold to 20 percent in line with the minimum acquisition threshold.

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[2] The proposed amendments would not substantively change the Asset Test.

Measuring Significance and Financial Statement Requirements

Using *pro forma* information to calculate significance

The proposed amendments would expand the circumstances in which a filer can use *pro forma* information to test significance. Currently, a filer can use *pro forma* information instead of historical information only if it has made a significant acquisition after the end of the last fiscal year and has already filed historical and *pro forma* financial statements regarding the acquired business. There is no such accommodation in a registration statement for an IPO or in the context of a disposal rather than an acquisition. The proposed amendments would expand use of *pro forma* information to these circumstances under certain conditions (though the *pro forma* information would have to exclude "Management's Adjustments" as discussed below).

Financial Statements of Significant Acquisitions: Periods to Be Included

Under the current rules, Rule 3-05 Financial Statements may be required for up to three years depending on the relative significance of the acquired or to-be-acquired business. The proposed changes would reduce the requirement from up to three years to up to two years, depending on the relative significance which, according to the SEC, "would be sufficient to allow investors to understand the possible effects of the acquired business on the registrant." The SEC noted that "older financial statements…can be less relevant for evaluating an acquisition because, due to their age, they are less likely to be indicative of the current financial condition, changes in financial condition and results of operations of the acquired business."

The chart below shows the current and proposed thresholds and the associated financial disclosure requirements:

Significance level	Current rules with regard to financial statements	Proposed Amendments
20% or less	No separate financial statements necessary.	No change.
Greater than 20%, but 40% or less	Audited financial statements of the acquired business are required for the **most recent fiscal year** and unaudited interim financial statements for the most recent interim period and the same period from the prior fiscal year for comparison.	Eliminate any comparison to prior interim period.
Greater than 40%, but 50% or less	Audited financial statements of the acquired business are required for the **two most recent fiscal years**. Unaudited interim financial statements for the most recent interim period and the same period from the prior fiscal year for comparison.	No change.
Greater than 50%	Audited financial statements of the acquired business are required for the **three most recent fiscal years**. Unaudited interim financial statements for the most recent interim period and the same period from the prior fiscal year for comparison.	Eliminate this tier of disclosure such that acquisitions with greater than 40% significance will require financials for the two most recent fiscal years.

Changes to Reporting Requirements for Specific Categories of Acquisitions

Reporting requirements when acquiring components of businesses

Currently, filers acquiring a component of an entity, rather than the entire entity, are required to include financials for the acquired component as if it were a complete "business" if it meets the definition of "business" and is sufficiently significant. These components may not have historical financial statements or separate accounts necessary to prepare Rule 3-05 financial statements. In recognition of the potential burden of

allocating the entity's corporate overhead, interest, and income tax expenses, the proposed amendments would allow filers to provide financial statements that omit these items. While the definition of "business" would not change, the reporting required for components that meet the definition would be reduced. This relief would only apply if, among other requirements: (i) the business constitutes less than substantially all of the assets and liabilities of the seller, (ii) separate financial statements have never been prepared, and (iii) the seller has not maintained the distinct and separate accounts necessary to present complete financial statements and it is impracticable to do so.

Individually Insignificant 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 mathematical majority of the group.

Due to this requirement, registrants often provide separate, audited historical financial statements for acquired businesses that are individually immaterial to the registrant as well as pro forma financial information that does not fully depict the aggregate effect of the "individually insignificant businesses."

The proposed amendments would still require pro forma financial information showing the aggregate effects of all acquisitions that together exceed 50 percent significance, but would only require historical financial statements for those businesses whose individual significance exceeds 20 percent (but are not yet required to file financial statements).

Omission of Acquired Business Financial Statements

Currently, separate audited annual and unaudited interim preacquistion financial statements are not required in a registration statement or proxy statement once the operating results of the target business have been reflected in the audited consolidated financial statements of the registrant for a complete fiscal year, unless (i) the financial statements have not been previously filed (as often is the case with an IPO company) or, (ii) even if previously filed, the acquired business is of major significance (*i.e.*, significant at the 80 percent level) to the registrant. As a result, an IPO company will have to obtain (or create) audited historical financial statements for any target business, even after the target has been consolidated in its financial statements for more than a year. In addition, a registrant would be required to include historical financial statements of a target business that may no longer be as significant as it was at the time of the acquisition.

Under the proposed amendments, financial statements would no longer be required in registration statements and proxy statements once the target business is reflected in filed post-acquisition company financial statements for a complete fiscal year.

Acquisition of a Foreign Business

The proposed amendments would allow for the Rule 3-05 financial statements to be prepared in accordance with IFRS-IASB without reconciliation with US GAAP, so long as the acquired business would qualify to use IFRS-IASB. This should allow issuers to more readily consider cross-border mergers that might not have otherwise taken place due to the high compliance costs of reconciling to US GAAP. In addition, if the acquired business prepares its financials using home country GAAP, such financials may be reconciled to IFRS-IASB (rather than US GAAP) as long as the filer is a foreign private issuer that uses IFRS-IASB.

Pro Forma Information

Under existing rules, *pro forma* financial statements may only present adjustments that are (i) directly attributable to the transaction, (ii) factually supportable, and, in the case of income statements (iii) expected to have a continuing impact (balance sheets include impacts regardless of whether they recur). They currently, in general, do not incorporate forward looking benefits of the transaction.

The proposed amendments would provide for greater flexibility in the presentation of *pro formas* to reflect transaction-related benefits, such as expected synergies from integration, by creating two categories of *pro forma* adjustments: "Transaction Accounting Adjustments" and "Management's Adjustments."

Transaction Accounting Adjustments

Transaction Accounting Adjustments would reflect only US GAAP or, if applicable, IFRS-IASB transaction accounting rules to the historical financial statements.

Management's Adjustments

Management's Adjustments would provide management flexibility to present the potential operational benefits of integration or disposal, *i.e.*, the expected synergies. The "Management's Adjustments" column would include the benefits of the transaction identified by management, such as the effect of closing facilities, discontinuing product lines, terminating employees, and executing new or modifying existing agreements. This column would include both recurring and non-recurring impacts of the transaction. For each Management's Adjustment, the proposed amendments would require: (i) a description of the synergy or other transaction effects, including material uncertainties; (ii) disclosure of the underlying material assumptions, method of calculation and estimated time frame for completion; (iii) qualitative information necessary to give a fair and balanced presentation of the pro forma financial information; and (iv) to the extent known, the reportable segments, products, services and processes involved, the material resources required (if any), and the anticipated timing.

Synergies or other transaction benefits would be limited to those that are (i) reasonably expected to occur and (ii) reasonably estimable (in contrast to the current "factually supportable" standard). For effects that are not reasonably estimable (and therefore not included in "Management's Adjustments"), the proposed amendments would require disclosure of qualitative information in the explanatory notes to the pro forma financial statements in order to ensure a fair and balanced presentation.

Key Takeaways and Practical Considerations

The proposal, if implemented, will reduce issuers' complexity and cost and facilitate more timely access to capital in a number of ways:

- Adding a revenue component and using market capitalization to measure "significance" will reduce the need for issuers without regular income to provide burdensome financial information for largely immaterial acquisitions.
- Allowing the omission of pre-acquisition financial statements of significant acquired businesses that have been included in a company's financial statements for a year will make the IPO preparation process for such companies faster and less costly.
- Shortening the maximum period for which financial statements of an acquired business are needed to two years, reducing the disclosure requirements for individually insignificant acquisitions, and increasing the significance threshold for dispositions to 20%, will ease the burden on certain issuers who have historically spent time and money on preparation of financial statements and pro forma financial information that did not significantly benefit investors.

However, the proposed revisions to the presentation of *pro forma* financial information create additional considerations that companies should be aware of:

- While the proposed revisions to *pro forma* financial presentation will allow issuers to better make the case to investors for pending acquisitions with detailed synergy disclosure, this disclosure will require additional judgement and analysis by management, and may increase preparation time.
- The new "Management's Adjustments" could expose issuers and other offering participants to potential liability for forward looking information that relies on judgements by management and estimates that are inherently uncertain. If the amendments are adopted, underwriters may find it advisable to increase due diligence efforts with respect to this disclosure, since it is unlikely that accountants will give meaningful comfort on these numbers.

Public comment on the proposed amendments must be received within the 60-day period following their publication in the Federal Register.

White & Case LLP
5 Old Broad Street
London
EC2N 1DW
United Kingdom
T +44 20 7532 1000

White & Case LLP
1221 Avenue of the Americas
New York, New York 10020-1095
United States
T +1 212 819 8200

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