SEC Adopts Rules for Financial Disclosure Requirements for Acquisitions and Dispositions

May 28, 2020

On May 21, 2020, the SEC adopted **amendments** to its financial disclosure requirements relating to acquisitions and dispositions of businesses. The new rules are intended to reduce the costs and complexity of required financial disclosure as part of the SEC's ongoing disclosure effectiveness initiative pursuant to its legislative mandate under the FAST Act of 2015 to modernize and simplify SEC reporting requirements. The SEC previously requested comment in both 2015 and 2019 on the effectiveness of financial disclosure requirements in Regulation S-X for entities other than the registrant, including for acquisitions and dispositions. The final rules are substantially similar to those proposed in 2019 and incorporate the SEC's consideration of the comments received in response to that request, including comments submitted by Davis Polk.

The new rules are a welcome easing of the burden of complying with certain of the current financial disclosure requirements for acquisitions and dispositions by limiting the requirements of financial statements for acquisitions that are clearly immaterial. Significantly, the new rules will:

- update the significance tests by:
  - revising the "investment test" to compare a company's investments in a target to the company's "aggregate worldwide market value";
  - revising the "income test" by adding a revenue component;
  - expanding the use of pro forma financial information in measuring significance; and
  - increasing the "significance threshold" for dispositions from 10% to 20%;
- shorten the period for which financial statements of an acquired business are required to be included to no more than the two most recent fiscal years;
- no longer require separate acquired business financial statements once the business has been included in the registrant's post-acquisition financial statements for nine months or a complete fiscal year, depending on significance; and
- amend the pro forma financial information requirements to improve the content and relevance of such information; including, pro forma adjustment criteria for:
  - "Transaction Accounting Adjustments" reflecting only the application of required accounting to the transaction;
  - "Autonomous Entity Adjustments" reflecting the operations and financial position of the reporting company as an autonomous entity if the registrant was previously part of another entity; and
  - optional "Management's Adjustments" depicting synergies and dis-synergies of the acquisitions and dispositions for which pro forma effect is being given if, in management's opinion, such adjustments would enhance an understanding of the pro forma effects of the transaction and certain conditions related to the basis and the form of presentation are met.

The rules go into effect on January 1, 2021 but voluntary compliance will be permitted in advance of the effective date.

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Modifications to the SEC's Significance Tests

The new rules modify the investment and the income tests which are applied to determine the significance of a business acquisition or disposition (as well as for determinations of a "significant subsidiary" under SEC rules more generally), while leaving the "asset test" (total assets of target compared to total assets of acquirer) substantively unchanged. These modifications are intended to more accurately reflect the relative significance of an acquisition or disposition to the reporting company, thereby reducing anomalous results.

Modifications to the Investment Test

Under the current rules, the investment test compares the company's investment in and advances to the acquired business to the company's total assets measured at book value. As provided in the proposal, the final rules revise the investment test to compare the company's investment in the target to the "aggregate worldwide market value" of the company's voting and non-voting common stock, when available, and to retain the existing test if a company does not have publicly traded common stock. In response to comments from Davis Polk and others, the final rules will require companies to use the aggregate of worldwide market value calculated daily for the last five trading days of the company's most recently completed month ending prior to the earlier of the company's announcement or agreement date of the acquisition or disposition. The rule, as modified, does not apply in connection with IPOs or include the value of debt of the acquirer. Accordingly, the rule is substantially improved but may continue to generate "false positives," requiring financial information for targets that are not material. We hope that the Staff continues to grant waivers where appropriate in such situations.

The final rules clarify that for acquisitions, the company's "investments in" the target is the consideration transferred, adjusted to exclude the company's proportionate interest in the carrying value of the assets transferred by the company to the target that will remain with the combined entity after the acquisition. The investment must include the fair value of contingent consideration if it is required to be recognized under the applicable accounting rules by the company at the acquisition date. If recognition of fair value is not required, the calculation must include all contingent consideration except contingent consideration for which the likelihood of payment is remote. Unlike the proposal, the final rules do not allow the exclusion of contingent consideration in the form of sales-based milestones and royalties when recognition of contingent consideration at fair value is not required under the accounting rules.

Likewise, for dispositions, the final rules provide that the company's "investments in" the tested subsidiary is the fair value of the consideration (which includes contingent consideration) for the disposed subsidiary when comparing to the aggregate worldwide market value of the company's voting and non-voting common equity, or, when the company has no such aggregate worldwide market value, the carrying value of the disposed subsidiary when comparing to total assets of the company.

Modifications to the Income Test

As with the asset test, the final rules modify the income test substantially as proposed. Under the current income test, significance is determined by comparing the target's and acquirer's income from continuing operations before taxes, extraordinary items and the cumulative effects of changes in account principle for the most recently completed fiscal year. The final rules introduce a new revenue alternative to the test that eliminates the need for financial statements where the target's revenues are relatively insignificant. This modification should reduce the anomalous results that occurred when an acquirer with low or no pre-tax income in a recent year may be more likely to have a target business deemed significant when in other respects it would not be so deemed.

To satisfy the income test under the final rules, the target must meet both the revenue and the net income portion of the test. The revenue component of the test compares the target's revenue to the acquirer's revenue for the most recently completed fiscal year. In a change from the proposal, the final rules require that the income component of the test compare income or loss from continuing operations *before* income taxes. In addition, the final rule also provides that if either the acquirer or the target did not have material revenue in each of the two most recently completed fiscal years, the revenue portion of the income test would not apply and the acquirer would use only the net income portion of the test. This change could have an impact on pre-revenue companies such as those in the biotech space.

Asset Test

Other than some clarifying changes, the asset test remains substantively unchanged.

Use of Pro Forma Financial Information to Measure Significance

The current rules generally do not permit the use of pro forma modifications to the financial statements when determining significance; however, pro forma modifications are permitted under the current rules if the company has made a significant acquisition subsequent to the last fiscal year and has filed the target's historical financial statement and pro formas on a Form 8-K.

The final rules expand circumstances in which a company may use pro forma financial information for significance testing. The new rules allow a company to measure significance for dispositions as well as acquisitions using filed pro forma financial information if the company has made a significant acquisition or disposition subsequent to the last fiscal year end for which the company's financial statements are required to be filed. This is subject to certain conditions, including that the company has filed pre-acquisition historical financial statements, if applicable, and pro forma information required for any such acquired or disposed business. The final rules eliminate the requirement in the current rule that such pre-acquisition financial statements and pro formas have been filed on Form 8-K, thus expanding the availability of pro forma modifications in significance testing for IPO registration statements. These pro formas, however, may use only transaction accounting adjustments; other adjustments such as autonomous entity adjustments, management's adjustments or other transactions such as use of proceeds from an offering. In addition, if a company uses pro formas to determine significance, it is required to continue to use pro formas to determine significance through the filing date of its next Form 10-K.

Financial Statement Requirements for Acquired Businesses

Periods to be Presented

The final rules eliminate the requirement to file a third year of audited financial statements for an acquired business or real estate operation where the significance exceeds 50%. The reporting company may use the lower of the current income component of the test and the new revenue component of the test to determine the number of periods for which financial statements are required. Thus, as modified, the financial statements required are as follows:

	Financial Statements Required	
Significance Level	**Current Rules**	**New Rules**
Less than 20% significance	No financial statements required	No financial statements required
Exceeds 20% but not 40% significance	*One* year of audited financial statements, and unaudited financial statements for most recent interim period and the corresponding prior year interim period	*One* year of audited financial statements, and unaudited financial statements for the most recent interim period (*no* comparative prior year interim period would be required) [1]
Exceeds 40% but not 50% significance	*Two* years of audited financial statements, and unaudited financial statements for the most recent interim period and the corresponding prior year interim period	Two years of audited financial statements, and unaudited financial statements for the most recent interim period and the corresponding

[1] A reporting company, however, may consider providing comparable prior financial statements for comparative purposes.

Significance Level	Financial Statements Required	
	Current Rules	New Rules
Exceeds 50% significance	*Three* years of audited financials, and unaudited financial statements for the most recent interim period and the corresponding prior year interim period	prior year interim period

Omission of Acquired Business Financial Statements

The final rules expand the circumstances in which an acquirer may omit the financial statements of a target beyond the current rules and the proposal. The new rules allow the omission of pre-acquisition financial statements for targets that exceed 20% but do not exceed 40% significance once they are included in company's post-acquisition financial statements for nine months. For targets that exceed 40% significance, financial statements may be omitted once they have been included in the acquirer's financial statements for a complete fiscal year. This change will address an issue often faced by IPO companies under the current rules, which require inclusion of target financial statements when the acquired business has already been reflected in the company's financial statements for a period of time.

Modifications to Certain Financial Statement Requirements

The final rules provide a number of other clarifications and flexibility with respect to financial statements required in particular circumstances, including the following:

- *Carve-Out Acquisitions*. When a company acquires a component of a business, such as a product line, it may present abbreviated financial statements of the target, provided that the following qualifying conditions are met:
  - the total assets and revenues of the target constitute 20 percent or less than those of the seller's as of and for the most recently completed fiscal year;
  - separate financial statements for the target have not previously been prepared;
  - the target was not a separate entity, subsidiary, operating segment (as defined in U.S. GAAP or IFRS-IASB, as applicable) or division during the periods for which the target's financial statements would be required; and
  - 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.
- *Oil and Gas Businesses*. For acquisitions of a business that includes "significant oil- and gas-producing activities," the final rules codify the SEC's practice of allowing companies to provide abbreviated financial statements. The financial statements may consist of income statements modified to exclude expenses not comparable to the proposed future operations, such as depreciation, depletion and amortization, corporate overhead expense, income taxes and interest expense, provide that certain conditions are met. The final rules only apply to a business that generates substantially all of its revenues from oil and gas producing activities.
- *Foreign Businesses*. Under the final rules, if the acquirer is a foreign private issuer that prepares its financial statements in accordance with IFRS-IASB, financial statements of a target that is a "foreign business" may be prepared using a comprehensive basis of accounting principles other than U.S. GAAP or IFRS-IASB and be reconciled to IFRS-IASB, not U.S. GAAP. For a target that is not a "foreign business," but would qualify as a foreign private issuer if it were an SEC registrant, financial statements may be prepared using IFRS-IASB without reconciliation to U.S. GAAP, or, if the acquirer is a foreign private issuer that prepares its financial statements using

IFRS-IASB, the target's financial statements may be prepared according to a comprehensive basis of accounting principles other than U.S. GAAP or IFRS-IASB and must be reconciled to IFRS-IASB or to U.S. GAAP.

Individually Insignificant Acquisitions

Under the current rules, if the aggregate impact of "individually insignificant businesses" exceeds 50% significance, registrants must provide pre-acquisition historical financial statements covering at least the substantial majority of the businesses acquired, as well as pro forma financial information. The final rules eliminate the requirement to provide pre-acquisition historical financial statements, thereby easing the burden on registrants with respect to individually insignificant acquisitions. Instead, when the aggregate impact of individually insignificant acquisitions exceeds 50% under any of the income, asset or investment tests, the reporting company may provide pro forma financial information depicting the aggregate effects of all such individually insignificant business and real estate operations acquisitions. When calculating the aggregate impact under the investment test, both business and real estate operations must be included. Pre-acquisition historical financial statements would only be required for those businesses whose individual significance exceeds 20% but are not yet required to file pre-acquisition historical financial statements. The following calculations are required when determining the aggregate impact of individually insignificant business:

- under the investment test, both business and real estate operations must be included;
- when determining whether both components of the investment test exceed 50%, businesses with losses must be aggregated separately from those with income; if either group exceeds 50%, then pro forma financial information will be required for both groups of businesses.

In its release, the SEC addressed concerns as to whether accountants would be able to provide negative assurance to underwriters on the combined pro forma financial information by noting that, in some circumstances, accountants might need to perform additional work to meet the "reasonable investigation" and "reasonable care" standard of the Securities Act of 1933, as amended (the "'33 Act"). However, the SEC did not provide any clarity on how this might be applied.

Presentation of Pro Forma Financial Information

Modifications to Pro Forma Adjustments

Under the current rules, a pro forma income statement is only permitted to reflect adjustments that are directly attributable to the transaction, expected to have a continuing impact on the company, and factually supportable. The pro forma balance sheet, however, can reflect adjustments that are directly attributable to the transaction and factually supportable, whether or not expected to have a continuing impact. The final rules, which are a modification of the proposal, replace the existing criteria with three categories of pro forma adjustments. The following two categories are required:

- *Transaction Accounting Adjustments*. These adjustments reflect the application of the accounting required by GAAP (or IFRS, if applicable). Adjustments to the pro forma income statement must be made whether or not the pro forma balance sheet is required to be presented. In addition, with respect to transaction accounting adjustments, the new rules require:
  - a table showing the total consideration transferred or received including its components and how they were measured, including a description of any contingent consideration; and
  - when the accounting is incomplete: a prominent statement to this effect and a description of certain related information.
- *Autonomous Entity Adjustments*. These adjustments depict the adjustments necessary to reflect the operations and financial position of the reporting company as an autonomous entity where it was previously part of another entity. In addition, with respect to autonomous entity adjustments, the new rules require:

- a description, of the adjustment (including the material uncertainties), the material assumptions, the calculation of the adjustment, and additional qualitative information about the autonomous entity adjustments, if any, necessary to give a fair and balanced presentation of the pro forma financial information.

The third category of pro forma adjustments is optional and may be presented if, in management's opinion, the adjustments would enhance an understanding of the effects of the transaction:

- *Management's Adjustments*. These adjustments depict synergies and dis-synergies of the acquisition or disposition and may only be presented if certain conditions are met, including:
  - there is a reasonable basis for each adjustment;
  - the adjustments are limited to the effect of such synergies and dis-synergies on the historical financial statements that form the basis for the pro forma statement of comprehensive income;
  - the pro forma financial information reflects all management's adjustments that are, in the opinion of management, necessary to a fair statement of the pro forma financial information presented and a statement to that effect is disclosed; and
  - when synergies are presented, any related dis-synergies must also be presented.

With respect to management's adjustments, the new rules require:

- disclosure of the basis for and material limitations of each adjustment, including any material assumptions or uncertainties, an explanation of the method of the calculation of the adjustment, if material, and the estimated time frame for achieving the synergies and dis-synergies of such adjustment; and
- that any management's adjustments included or incorporated by reference into any filing should be as of the most recent practicable date prior to the filing's effective date, mail date, qualification date, or filing date as applicable; thus, they may be required to be updated if previously provided in a Form 8-K that is appropriately incorporated by reference.

In addition, any "forward-looking" information in management's adjustments in the safe harbors in the '33 Act and the Securities Exchange Act of 1934.

The new rules require transaction accounting adjustments and autonomous entity adjustments to be presented in separate columns in the pro forma financial statements. Management's adjustments, if any, must be in the explanatory notes to the pro forma financial information in the form of reconciliations of pro forma net income and related pro forma earnings per share data after giving effect to the adjustments. All pro forma financial information must disclose revenues, expenses, gains, losses and related tax effects that will not recur in the income of the company beyond 12 months after the transaction. If the transaction is structured in such a manner that significantly different results may occur, additional pro forma presentations that give effect to the range of possible results must be included. Historical and pro forma revenue per share information must be on the pro forma income statement and may only give effect to transaction accounting adjustments and autonomous entity adjustments.

Significant Threshold for Business Dispositions

The final rules also raise the significance threshold for the disposition of a business from 10% to 20% to align with the threshold at which an acquired business is deemed significant under the SEC's rules. In addition, the tests used to determine significance of a disposed business would be conformed to those used to determine significance of an acquired business.

Other Changes

The new rules generally align Rule 3-14 of Regulation S-X relating to financial statements for acquired real estate operations with the amendments to Rule 3-05 (where no unique industry considerations exist).

In respect of investment companies, the final rules add a definition of "significant subsidiary" to Regulation S-X that is specifically tailored for investment companies based on Section 8 of the Investment Company Act. In addition, the rules add new Rule 6-11 and amend Form N-14 to cover financial reporting for fund acquisitions by investment companies and business development companies. The current pro forma financial information requirement will be replaced with a requirement to provide supplemental financial information.

Transition Period

Reporting companies will be required to comply with the new rules beginning in their fiscal year beginning after December 31, 2020. Companies filing an IPO will not be required to comply until the first registration statement is filed on or after the mandatory compliance date. After that date, all probable or consummated acquisitions and dispositions, including those consummated prior to the mandatory compliance date, must be evaluated for significance under the new rules.

Voluntary early compliance with the new rules is permitted, provided that the new rules are applied in their entirety.

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