SEC Proposes to Simplify Financial Disclosure for Acquisitions and Dispositions

May 7, 2019

On May 3 the SEC proposed **amendments** to the financial disclosure requirements relating to acquisitions and dispositions of businesses. The proposed amendments are intended to reduce the costs and complexity of required financial disclosure and should reduce the circumstances under which financial statements for acquired businesses need to be filed. The SEC previously **requested** comment in 2015 on the effectiveness of financial disclosure requirements for entities other than the registrant, including for acquisitions and dispositions, as part of its ongoing disclosure effectiveness initiative pursuant to its mandate under the FAST Act of 2015 to modernize and simplify public-company reporting requirements. This proposal incorporates the SEC's consideration of comments received from Davis Polk and others in response to that request.

We believe this proposal is a step in the right direction of easing the burden of complying with current financial disclosure requirements for acquisitions and dispositions without meaningfully impacting the flow of material information to investors. Significantly, the proposed amendments would:

- revise the "investment test" and "income test" used to determine the significance of an acquisition or disposition and expand the use of pro forma financial information to determine significance;
- increase 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 at most two fiscal years (rather than up to three fiscal years), and eliminate any requirement for financial statements of an acquired business after the acquisition has been reflected for a complete fiscal year regardless of significance;
- introduce new flexibility around pre-acquisition historical financial statements for acquired businesses; and
- modify pro forma requirements to improve content and relevance, and in particular require presentation of management adjustments (such as those relating to synergies and other effects of the transaction) as a separate column in the pro forma financial statements.

The SEC is soliciting public comment on the proposal for 60 days after its publication in the Federal Register, likely through mid-July.

Modifications to the Significance Tests

The proposal would modify the investment and income tests that 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 the target vs. total assets of the acquirer) substantively unchanged. These modifications would more accurately reflect the relative significance of an acquisition or disposition to the reporting company, and also reduce so-called "false positives" or anomalous results.

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Modifications to the Investment Test

Under current rules, the investment test compares the company's investment in the acquired business to the company's total assets. The proposed amendments would instead require a comparison of the company's investment in the acquired business to the "aggregate worldwide market value" of the company's voting and non-voting common equity, when available. If the company does not have publicly traded common equity, the current investment test would continue to apply. The SEC's proposal would require market value to be determined as of the last business day of the company's most recently completed fiscal year prior to closing the acquisition.

The proposed modification to the investment test is a welcome change and reflects one of the proposals in our comment letter to the SEC. However, the current proposal to test market capitalization as of the end of the company's most recently completed fiscal year seems arbitrary and may still lead to false positives. For example, depending on the deal timeline relative to the company's fiscal year, market capitalization may be stale relative to the acquisition or may reflect news of the acquisition. We would hope the SEC will include flexibility in the new test to allow companies to measure worldwide market value at a date within 60 days prior to public announcement of the acquisition, which we believe would lead to a comparison that is more meaningful to investors. Moreover, the test should also allow the addition of the acquirer's outstanding debt to its equity market value so that the test more accurately compares enterprise value of the target to enterprise value of the acquirer.

Modifications to the Income Test

Under the current income test, significance is determined by comparing the target's and the acquirer's income from continuing operations before taxes, extraordinary items and cumulative effects of changes in accounting principles. The proposal would introduce a new revenue alternative to the test which could be used to excuse the need for financial statements where the target's revenues are relatively insignificant. This should be of help to companies with low or negative GAAP net income.

The revenue component of the test would compare the target's revenue to the acquirer's revenue. The reporting company would use the lower of the current income component of the test and the new revenue component of the test to determine the significance of the acquisition.

In addition, the proposed modifications would require that the income component compare income or loss from continuing operations *after* taxes, which would permit a company to use line item disclosure from its financial statements and thereby simplify the determination. This encouraging change also reflects one of the proposals in our comment letter to the SEC.

Overall, we believe these modifications to the income test should help reduce false positives in cases where the reporting company has low or negative pre-tax income (e.g., due to high interest expense) and the target has little or no debt, and also safeguard against false positives in other situations where the reporting company has low income or a loss from continuing operations.

Asset Test

Other than some clarifying changes, the asset test would remain substantively unchanged. While the changes to the investment and income tests are welcome, the asset test can also lead to false positives in circumstances similar to the current investment test. For example, many technology companies that were built organically do not have sizable GAAP assets, and so an acquisition can trigger a finding of significance even when the target is small compared to the company's market capitalization. Accordingly, we would hope that the SEC will include a market capitalization concept for the asset test in a manner similar to the investment test in its final rule.

Use of Pro Forma Financial Information to Measure Significance

The current rules generally do not permit pro forma modifications to the financial statements of the company and the target to be used to determine significance. Thus, generally speaking, significance is determined by comparing the most recent annual financial statements of the target to those of the

reporting company prior to the date of the acquisition. Pro forma modifications to financial information are permitted to be used under the current rules only if the company has made a significant acquisition subsequent to the last fiscal year and has filed the target's historical financial statements and pro formas on Form 8-K.

The proposed amendments would expand the circumstances for using pro forma financial information in significance testing. In addition to significant acquisitions, the amendments would allow companies to measure significance using filed pro forma financial information if the company has made a significant *disposition* subsequent to the last fiscal year, as long as pro forma information has been filed for the disposition. In addition, the amendment would allow the use of such pro forma information for significance testing in initial public offerings.

The proposed changes would not, however, permit companies to include the management adjustments described below when using pro forma financial information to determine significance.

Financial Statements of the Acquired Business

The proposed amendments would eliminate the current requirement to file a third year of audited financial statements for an acquired business where significance exceeds 50%. This element of the proposal is particularly sensible because rarely would such stale information be of interest to an acquiring company's shareholders, and yet for many non-public targets it can be difficult and costly to prepare. Target financial statements would be required as follows:

<table>
<tr><th rowspan="2">Significance Level</th><th colspan="2">Target Financial Statements Required</th></tr>
<tr><th>Current</th><th>Proposed</th></tr>
<tr><td>Less than 20%</td><td>No financial statements required</td><td>Same</td></tr>
<tr><td>Exceeds 20% but not 40%</td><td>One year of audited financial statements, and unaudited financial statements for most recent interim period and the corresponding prior year interim period</td><td>Same, but comparative prior year interim period would not be required</td></tr>
<tr><td>Exceeds 40% but not 50%</td><td>Two years of audited financial statements, and unaudited financial statements for the most recent interim period and the corresponding prior year interim period</td><td rowspan="2">Two years of audited financial statements, and unaudited financial statements for the most recent interim period and the corresponding prior year interim period</td></tr>
<tr><td>Exceeds 50%</td><td>Three years of audited financials, and unaudited financial statements for the most recent interim period and the corresponding prior year interim period</td></tr>
</table>

Despite the proposed changes where the significance level exceeds 20% but does not exceed 40%, it is not clear if the auditors would nevertheless require prior year interim financials for purposes of comfort.

Omission of Acquired Business Financial Statements

The proposed amendments would address an issue often arising in IPO registration statements by eliminating the current requirement to provide target financial statements even though the target has been reflected in the company's post-acquisition financial statements for a complete fiscal year, when the acquired business is of "major significance" (i.e., significant at the 80% level) or the target financial statements have not been previously filed. The proposal would no longer require such financial statements once the acquired business is reflected in the company's post-acquisition financial statements for a complete fiscal year.

Other Modifications

The proposal would introduce a number of other clarifications and flexibility with respect to required target financial statements, including the following:

- *Carve-Out Acquisitions.* When a company acquires a component of an entity (such as a product line or line of business) that is a "business," financial statements for the acquired component may not be readily available from the seller. Moreover, it may be impracticable to prepare financial statements because of the need to allocate the seller's corporate overhead, interest and income tax expenses. Accordingly, the proposal would allow companies to provide audited statements of assets acquired and liabilities assumed, and statements of revenues and expenses that exclude allocations of corporate overhead, interest and income tax expenses, if certain requirements are met.
- *Oil and Gas Businesses.* For acquisitions that include "significant oil- and gas-producing activities," the proposed amendments would codify the SEC staff's practice of allowing companies to provide abbreviated financial statements. Such financial statements may consist of income statements modified to exclude certain expenses, such as depletion, depreciation, and, if not comparable to future operations, amortization expense, corporate overhead expense, income taxes and interest expense, provided certain conditions are met.
- *Foreign Businesses*. The proposal would permit the financial statements of a target that is not a "foreign business," but would qualify to use IFRS-IASB if it were an SEC registrant, to be prepared in accordance with IFRS-IASB without reconciliation to US GAAP. (Reconciliation, however, may still be required in order to produce pro formas.) In addition, if the target is a "foreign business" and prepares its financial statements using home country GAAP, a company that is a foreign private issuer and prepares its financial statements using IFRS-IASB would be permitted to reconcile the target's financial statements to IFRS-IASB rather than US GAAP.
- *Individually Insignificant Acquisitions*. Under current rules, if the aggregate significance of "individually insignificant businesses" (together with any acquired businesses which are significant but for which financial statements are not yet required because of the 75-day grace period) exceeds 50%, companies must provide pre-acquisition historical financial statements covering at least the "substantial majority" of the businesses acquired, as well as pro forma financial information. Under the proposal, companies would still be required to provide pro forma financial information depicting the aggregate effects of all such acquisitions. Historical financial statements would only be required for those businesses whose individual significance exceeds 20% instead of for the "substantial majority" of all such acquisitions.

Pro Forma Financial Information

Under 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, 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 proposed amendments would replace these existing criteria with the following two categories of pro forma adjustments:

- *Transaction Accounting Adjustments.* These adjustments would depict in the pro forma balance sheet and income statement the accounting for the transaction required by GAAP (or IFRS, if applicable).
- *Management Adjustments.* These adjustments would be required for synergies and other effects of the transaction, such as closing facilities, discontinuing product lines, terminating employees and executing new or modifying existing agreements, that are both reasonably estimable and either have occurred or are reasonably expected to occur. For effects that are not reasonably estimable, the proposal 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.

The proposal would require transaction accounting adjustments and management adjustments to be presented in separate columns. In addition, the proposed changes would introduce specific disclosure requirements with respect to management adjustments, including requiring:

- a description of the synergy or other transaction effects, including material uncertainties;
- disclosure of the underlying material assumptions, method of calculation and estimated time frame for completion; and
- qualitative information necessary to give a fair and balanced presentation of the pro forma financial information.

While greater clarity around the nature of permitted adjustments is helpful, the requirement to present reasonably estimable synergies and other transaction effects that have occurred or are reasonably expected to occur creates potential liability with respect to such adjustments for companies and, in the context of a securities offering, underwriters. We hope the SEC will address the potential for such liability in the final rule amendments by extending the safe harbor for forward-looking statements to the management adjustment column, including in IPOs and exchange offers.

Significance Threshold for Dispositions

The proposed amendments would raise the significance threshold for the disposition of a business from 10% to 20% to align with the threshold for acquisition significance. 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 Proposed Changes

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

In addition, the proposed amendments would add a definition of “significant subsidiary” to Regulation S-X that is specifically tailored for business development companies and other investment companies, and would add a new Rule 6-11 modeled after proposed Rules 3-05 and 3-14 of Regulation S-X. The current pro forma financial information requirement would be replaced with a requirement to provide supplemental financial information.

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