SEC Proposes Welcome Streamlining Of M&A Disclosures

By **Andrew Brady, Ryan Adams, Michael Zeidel and Meyghan McCrea** (June 14, 2019, 1:39 PM EDT)

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On May 3, 2019, the U.S. Securities and Exchange Commission proposed extensive changes to the financial disclosure requirements under Regulation S-X for business acquisitions and dispositions. The proposed amendments are a welcome development, and the latest in a series of actions by the SEC seeking to simplify line-item disclosures with respect to capital formation, and reduce the time and expense associated with preparing them, while ensuring that investors are still provided with meaningful information to make their investment decisions.

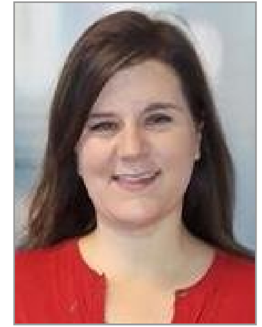
The proposed amendments would have significant implications for reporting companies. Certain of the more prominent changes and key takeaways related to such changes include:

- Updating the "investment test" and "income test," which represent two of the three tests used to determine whether an acquisition or disposition is significant. These changes would better reflect the relative significance of a subject acquisition or disposition, and thereby reduce anomalous results where comparatively insignificant transactions trigger burdensome disclosures.

- Reducing the maximum periods of time for which audited financial statements would be required for significant acquisitions from three years to two years. Eliminating the requirement to include a third year of audited target financial statements should significantly reduce the costs and time required to prepare the Rule 3-05 disclosures, and acknowledges that older preacquisition financial statements generally are not necessary for investors to understand the possible effects of the acquired business on the registrant.

- Formalizing an existing SEC staff practice that conditionally permits the use of abbreviated financial statements of an acquired business that is a partial component of an entity where separate financial statements are not available. The impact of these changes is another welcome elimination of costly disclosure; investors would be protected by the specific criteria that must be satisfied to provide abbreviated financial statements, and the requirements related to their content. But to the extent such alternative disclosures are not derived from audited financial statements of the acquired companies, diligence and audit concerns may be implicated.

- Revising the scope of adjustments permitted in pro forma financials to include "transaction accounting adjustments" and "management's adjustments." The proposed amendments would replace the existing restrictive adjustment criteria with simplified requirements. Critically, the proposed amendments would permit management's adjustments to include forward-looking information that depicts certain anticipated synergies, efficiencies and other transaction effects identified by management. To the extent adjustments include forward-looking statements, counsel should ensure that each statement falls within an appropriate safe harbor, if available, and does not raise diligence concerns, and that early conversations with the auditors address any issues related to comfort for any adjustments.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A more detailed summary of these, and certain other proposed changes follows. The comment period on the proposed rules closes July 29, 2019.

Updates to Significance Tests

When a registrant acquires a significant business, Rule 3-05 generally requires disclosure of separate audited annual and unaudited interim preacquisition financial statements of that business, while Article 11 of Regulation S-X requires that the registrant file related unaudited pro forma financial information.

The SEC has proposed revising the "investment" and "income" tests in Rule 1-02(w) that are used to determine significance, while leaving the "asset" test unchanged.

Investment Test

Currently, the investment test compares the registrant's investment in the target business to the registrant's total assets to determine significance. The revised test aligns itself more closely with the economic significance of the acquisition to the registrant by comparing the registrant's investment in the target business to the "aggregate worldwide market value of the registrant's voting and non-voting common equity," when available.

The new investment test would calculate market value (which would include common equity held by affiliates) as of the last business day of the registrant's most recently completed fiscal year prior to closing the acquisition. Where a registrant does not have an aggregate worldwide market value as of such date, the SEC proposed retaining the existing investment test.

Income Test

The income test evaluates significance by comparing the target and the registrant's income from continuing operations before taxes, extraordinary items and cumulative effects of changes in accounting principles. The current income test is subject to anomalous results because it focuses only on a single component: net income, which can include infrequent expenses, gains and losses. Proposed revisions would use after-tax income, permitting the registrant to use line item disclosure from its financial statements, simplifying calculations.

The revisions also would add a new revenue component, which would compare the target's revenue to the registrant's revenue. The registrant 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. Where a registrant or target does not have recurring annual revenues, only the net income component would apply.

Significance Threshold and Tests for Dispositions

Currently, pro forma financial information is required upon the disposition or probable disposition of a significant portion of a business if that disposition is not fully reflected in the financial statements of the registrant. The proposed amendments would raise the significance threshold under Rule 1-02(w) from 10% to 20%, and conform the disposition significance test to align with those applicable to

acquisition significance.

Pro Forma Financial Information to Measure Significance

Significance determinations generally are required to be made by comparing the most recent annual financial statements of the target to those of the registrant prior to the date of the acquisition. A registrant, however, is permitted to use pro forma, rather than historical, financial information to determine significance, if the registrant has made a significant acquisition subsequent to the last fiscal year, and has filed the target’s historical financial statements and pro formas on a Form 8-K.

The proposed amendments would expand the circumstances for using pro forma financial information in measuring significance to include IPOs and cases when the registrant has made a significant disposition, as long as pro forma information has been filed. Registrants could include "transaction accounting adjustments," but not "management's adjustments" (described below), in determining significance under this section.

Financial Statements of Significant Acquisitions: Periods to Be Included

The proposed amendments would change the maximum number of years of a target business' required Rule 3-05 Financial Statements of from three to two, depending on significance, as follows:

<table>
<tr><th colspan="3">Target Financial Statements Required</th></tr>
<tr><th>Significance Level</th><th>Current</th><th>Proposed</th></tr>
<tr><td>Less than 20%</td><td>No financial statements required</td><td>No financial statements required</td></tr>
<tr><td>Greater than 20%, but not 40%</td><td>One year of audited financial statements, and unaudited financial statements for the most recent interim period and the corresponding prior year interim period</td><td>One year of audited financial statements, and unaudited financial statements for the most recent interim period without the corresponding prior year interim period</td></tr>
<tr><td>Greater than 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>Greater than 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>
<tr><td>Greater than 80%</td><td>Rule 3-05 exemption from providing separate financials if operating results of target business have been reflected in the audited financial statements of the registrant for a complete fiscal year does not apply, if acquired business is of major significance (i.e., significant at the 80% level) at the date of purchase.</td><td>Rule 3-05 exemption applies regardless of significance of acquired business.</td></tr>
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Abbreviated Financial Statements for Partial Components of an Entity

Registrants frequently acquire a component of an entity, such as a product line, that is a “business” as defined in Rule 11-01(d) of Regulation S-X, but that does not constitute a separate entity, subsidiary or division. Such business may not have separate financial statements or maintain

separate and distinct accounts necessary to prepare Rule 3-05 Financial Statements.

Recognizing that providing Rule 3-05 financial statements for the target business may be impracticable, Rule 3-05(e) would be added to allow companies to provide "abbreviated financial statements"[1] if the following requirements are met:

- The business constitutes less than substantially all of the assets and liabilities of the seller, and was not a separate entity, subsidiary, segment or division during the periods for which the acquired business financial statements would be provided;

- Separate financial statements for the business have not been prepared previously; and

- The seller has not maintained the separate accounts necessary to present financial statements that include the omitted expenses, and it is impracticable to prepare such financial statements.

The proposed amendments provide guidance on presentation of the abbreviated financials, and would require inclusion of certain explanatory disclosures.

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.

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

The proposed amendments still would require pro forma financial information depicting the aggregate effects of all such acquisitions that together exceed 50% significance, but historical financial statements only would be required for those businesses whose individual significance exceeds 20%.

Pro Forma Financial Information

Pro forma financial information is intended to reflect the impact of an acquisition on an ongoing basis, and typically includes the most recent balance sheet and most recent annual and interim period income statements. Pro forma financial information for a business acquisition combines the historical financial statements of the registrant and the target business, and is currently adjusted only where specified criteria are met.

The proposed amendments would simplify the requirements, creating two categories of pro forma adjustments: (1) transaction accounting adjustments and (2) management's adjustments.

Transaction accounting adjustments would depict in the pro forma balance sheet and income statement the required accounting of the acquisition, disposition or other transaction.

Management's adjustments would be required for, and limited to, synergies and other effects of the transaction, such as closing facilities, discontinuing product lines and terminating employees, that are both reasonably estimable and have occurred or are reasonably expected to occur. For effects that are not reasonably estimable, the registrant would be required to disclose qualitative information in the explanatory notes to the pro forma financial statements in order to ensure a fair and balanced presentation.

Management's adjustments would be subject to specific presentation requirements, and be

accompanied by requisite disclosures describing the adjustments, the assumptions on which they are based, their method of calculation, and certain timing and other qualitative information.

Other Changes

The SEC also proposed a variety of additional changes, including the following.

Omission of Acquired Business Financial Statements

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.

This change would eliminate the requirement to provide financial statements when they have not been previously filed, or if they have, when the acquired business is of major significance. IPO issuers, for example, no longer would have go back and obtain (or create) audited historical financial statements for certain significant target businesses, even after the target has been consolidated in its financial statements for more than a year.

Foreign Businesses

Rule 3-05 would be amended to permit a reporting company to prepare a target company's financial statements following International Financial Reporting Standards as issued by the International Accounting Standards Board (IFRS-IASB) without reconciliation to U.S. GAAP, if the acquired business would qualify to use IFRS-IASB if it were a registrant.

IFRS-IASB companies could also reconcile to home country GAAP rather than U.S. GAAP, avoiding a one-time presentation of the U.S. GAAP reconciling information.

Real Estate Operations

The proposed amendments generally would 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).

Smaller Reporting Companies

The proposed amendments would make corresponding changes to the smaller reporting company requirements in Article 8 of Regulation S-X.

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[1] Defined as 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.

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