Capital Markets Alert

Skadden

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SEC Adopts Changes to Financial Disclosure Requirements for Acquisitions and Dispositions

If you have any questions regarding the matters discussed in this memorandum, please contact the attorneys listed on the last page or call your regular Skadden contact.

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On May 21, 2020, the Securities and Exchange Commission (SEC) adopted extensive changes to the financial disclosure requirements for business acquisitions and dispositions. The amendments are intended to reduce the complexity and costs associated with the preparation of historical financial statements and *pro forma* financial information, primarily by amending Rule 3-05 and Article 11 of Regulation S-X. The amendments are welcome developments that represent an additional example of the SEC taking concerted action to ease disclosure requirements with respect to capital formation in a manner that ensures investors continue to have access to meaningful information. The amendments will be effective on January 1, 2021, but voluntary compliance will be permitted in advance of the effective date.

Among the more prominent changes, the amendments will:

- Revise the "investment test" and "income test" used to determine the significance of an acquisition or disposition, conform the significance threshold and tests for a disposed business, and expand the use of *pro forma* financial information in measuring significance;
- Reduce the number of audited and interim periods for which historical financial statements must be presented if an acquisition is determined to be significant to a maximum of the two most recent fiscal years;
- Permit abbreviated financial statements of a target business carved out of a broader entity that did not maintain separate financial statements of the target business;
- No longer require separate financial statements for any acquired business once it has been included in the registrant's audited post-acquisition financial statements for nine months or a complete fiscal year, depending on significance of the acquired business;
- Expand the use of, or reconciliation to, International Financial Reporting Standards as issued by the International Accounting Standards Board (IFRS-IASB);
- Ease the requirement to provide financial statements and *pro forma* financial information for "individually insignificant acquisitions"; and
- Modify the form and content of *pro forma* financial information by replacing the current restrictive criteria imposed on *pro forma* adjustments with two new categories of mandatory adjustments to be presented as separate columns: (i) "transaction accounting adjustments" that will reflect the estimated purchase accounting under U.S. generally accepted accounting principles (GAAP) or IFRS-IASB, and (ii) "autonomous entity adjustments" that will reflect the operations and financial position of the [registrant] as an autonomous entity if the [registrant] was previously part of another entity. Additionally, registrants also

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may elect to disclose certain "management's adjustments," which would include reasonably estimable synergies, dis-synergies, and other transaction effects that have occurred or are reasonably expected to occur, so long as certain requirements are met.

The amendments will not apply to target company financial statements required to be included in a proxy statement or registration statement on Form S-4 or Form F-4 but will apply to the *pro forma* information provided therein pursuant to Article 11 and any financial information for other acquisitions and dispositions that is required to be disclosed in the registration statement pursuant to Rule 3-05 or Rule 3-14 (*e.g.*, registrant or target company acquirees), which will be aligned, where no unique industry conditions exist.

Background

When a registrant acquires a significant business, other than a real estate operation, Rule 3-05 historically has required disclosure of separate audited annual and unaudited interim pre-acquisition financial statements of that business if it is significant to the registrant (Rule 3-05 Financial Statements). Significance is determined by applying investment, asset and income tests set forth in Rule 1-02(w) of Regulation S-X. Similar rules apply to real estate operations and are set forth in Rule 3-14 of Regulation S-X.

Article 11 of Regulation S-X also has provided that registrants required to file Rule 3-05 or Rule 3-14 historical financial statements were additionally required to file unaudited *pro forma* financial information relating to an acquisition or disposition, which typically included a *pro forma* balance sheet and *pro forma* income statements based on the historical financial statements of the registrant and the acquired or disposed business. *Pro forma* financial information included adjustments intended to show how the acquisition or disposition might have affected those financial statements.

Updates to Significance Tests

The amendments revise the significance tests in Rule 1-02(w) that are used to determine whether a registrant is required to provide the historical financial statements of a business it acquires and, if so, how many periods must be presented. The changes, which revise the calculation of significance under the Investment Test and the Income Test of Rule 1-02(w) while leaving the Asset Test substantively unchanged, are aimed at helping registrants make more meaningful significance determinations and reducing the need for registrants to seek SEC staff relief under Rule 3-13 of Regulation S-X in the case of anomalous results.[1]

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 aims to align 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. Aggregate worldwide market value (which includes common equity held by affiliates) will be averaged over 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. Where a registrant does not have an aggregate worldwide market value, the SEC will retain the existing Investment Test.

Income Test

Historically, the Income Test has evaluated 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.

The revised Income Test adds a new revenue component, which will compare the target's revenue to the registrant's revenue. To satisfy the Income Test under the final amendments, the tested subsidiary must meet both the revenue component and the net income component when the revenue component applies and, for purposes of the application of Rule 3-05, may use the lower of the revenue component and the net income component to determine the number of periods for which Rule 3-05 Financial Statements are required. Where a registrant or target does not have recurring annual revenues in each of the two most recently completed fiscal years, only the net income component will apply.

While the SEC initially proposed moving from a pre-tax method to an after-tax method of calculation of net income to simplify calculations by permitting line-item disclosure from a registrant's financial statements, the final rules included in the amendments retain the before-tax framework. In maintaining the existing method of calculation, the SEC agreed with commenters that after-tax calculations were susceptible to distortions such as entity tax status and income tax volatility, which would tend to make the after-tax number less meaningful to investors.

[1] In addition to the changes to the significance tests, the SEC has adopted clarifying amendments to the definition of "significant subsidiary" to label the conditions as the "Investment Test," the "Asset Test" and the "Income Test."

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 either by sale, abandonment or distribution to shareholders by means of a spin-off, split-up or split-off, if that disposition is not fully reflected in the financial statements of the registrant. A disposition of a business is considered significant if it meets the conditions of a significant subsidiary under Rule 1-02(w), using a 10% significance threshold.

The amendments will raise the significance threshold from 10% to 20% to align with the threshold for acquisition significance. In addition, the tests used to determine significance of a disposed business will be conformed to those used to determine significance of an acquired business.

Pro Forma Financial Information to Measure Significance

Currently, 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. Prior to adoption of the amendments, there was no analogous provision in Rule 3-05 for registrants to use *pro forma* financial information depicting significant dispositions or for registrants filing initial public offerings (IPOs).

The amendments expand the circumstances for using *pro forma* financial information in measuring significance. In addition to significant acquisitions, the amendments allow registrants to measure significance using filed *pro forma* financial information if the registrant 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 amendments permit the use of such *pro forma* information for significance testing in IPOs. The changes will not, however, permit registrants to include "autonomous entity adjustments" or "management's adjustments," described below, when using *pro forma* financial information to determine significance. Rather, the *pro forma* financial information must be limited to the applicable subtotals that combine historical financial information of the registrant and the acquired business, as well as "transaction accounting adjustments." Once a registrant uses *pro forma* financial information to measure significance, it must continue to use *pro forma* financial information to do so until its next annual report.

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 amendments reduce the number of years of required Rule 3-05 Financial Statements from three years to up to two years, depending on the relative significance. According to the SEC, two years of pre-acquisition financial statements "[is] sufficient to allow investors to understand the possible effects of the acquired business on the registrant," and "older financial statements, such as the third year of Rule 3-05 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."

Under the new rules, Rule 3-05 Financial Statements will be required as follows:

<table>
<tr><th colspan="3">Target Financial Statements Required</th></tr>
<tr><th>Significance Level</th><th>Current</th><th>Amended</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 most recent interim period and the corresponding prior year interim period</td><td>One year of audited financial statements, and unaudited financial statements for 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>
</table>

Abbreviated Financial Statements for Partial Components of an Entity

Registrants frequently acquire a component of an entity, such as a product line or a line of business contained in more than one subsidiary of the selling entity that is a "business" as defined in Rule 11-01(d) of Regulation S-X but does not constitute a separate entity, subsidiary or division. These businesses may not have separate financial statements or maintain separate and distinct accounts necessary to prepare Rule 3-05 Financial Statements because they often represent only a small portion of the selling entity. Historically, registrants have needed to seek relief from the SEC staff or rely on informal guidance to provide abbreviated financial statements in such situations.

Recognizing that making relevant allocations of the selling entity's corporate overhead, interest and income tax expenses necessary to provide Rule 3-05 Financial Statements for the target business may be impracticable, the amendments add a new rule, Rule 3-05(e). This rule will allow companies to provide audited statements of assets acquired and liabilities assumed, as well as statements of revenues and expenses that exclude allocations of certain corporate overhead, interest and income tax expenses, which the SEC refers to as "abbreviated financial statements," if the following requirements are met:

- the total assets and total revenues (both calculated after inter-company eliminations) of the acquired — or to be acquired — business constitute 20% or less of such corresponding amounts of the seller and its subsidiaries, consolidated as of and for the most recently completed fiscal year;
- the acquired business 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 acquired business financial statements would be required;
- separate financial statements for the business have not previously been prepared; 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.

A registrant may not exclude from abbreviated financial statements various items such as interest expense for debt assumed from the seller or various operating expenses paid by or on behalf of the business during the pre-acquisition period, such as selling, distribution, marketing, general and administrative, and research and development, and depreciation and amortization expenses. The notes to the abbreviated financial statements also must include disclosure about the type of omitted expenses, the reasons why they were excluded and how the statements are not indicative of the acquired business going forward, as well as available information about the operating, investing and financing cash flows of the business.[2]

Omission of Acquired Business Financial Statements

Currently, Rule 3-05 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% level) to the registrant. In the former case, an IPO company will need to go back and 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 the latter case, the registrant will need to include historical financial statements of a now-consolidated target business that may no longer be as significant to the registrant as it was at the time of the acquisition.

Under the amendments, financial statements no longer will be required in registration statements and proxy statements once the target business is reflected in the registrant's audited post-acquisition financial statements for nine months, if the target company has 20-40% significance, and if significant at greater than 40%, for a complete fiscal year. The SEC observed that the nine-month period applicable to target businesses significant at the 20%-40% level has the advantage of aligning Rule 3-05 with Rule 3-06, which permits the filing of nine months of financial statements to satisfy the one-year financial statement requirement for target businesses at this significance level.

The amendments also eliminate the requirement to provide financial statements when they have not been previously filed or when they have but the acquired business is of major significance.

Foreign Businesses

The test to determine whether a target is a "foreign business" — permitting Rule 3-05 Financial Statements to be presented in IFRS-IASB instead of U.S. GAAP — is more stringent as it relates to certain equity ownership requirements than the "foreign private issuer" definition. The divergent definitions have created a circumstance where an acquired business that does not meet the definition of foreign business, but would otherwise be permitted to present its financial statements using IFRS-IASB as a foreign private issuer, is not permitted to use financial statements prepared in accordance with IFRS-IASB for its Rule 3-05

[2] The amendments create similar requirements in new Rule 3-05(f) for businesses engaged in oil- and gas- producing activities.

Financial Statements even when those financial statements are already available. Instead, the Rule 3-05 Financial Statements must be prepared in accordance with U.S. GAAP, which can result in a significant cost to the registrant.

The amendments permit Rule 3-05 Financial Statements to be prepared in accordance with IFRS-IASB without reconciliation to U.S. GAAP if the acquired business would qualify to use IFRS-IASB if it were a registrant. The amendments also will permit foreign private issuers that prepare their financial statements using IFRS-IASB to provide Rule 3-05 Financial Statements of foreign businesses prepared using home country GAAP to be reconciled to IFRS-IASB rather than U.S. GAAP. Acquired businesses that do not meet the definition of a foreign business, but would qualify as foreign private issuers if they were registrants, will be allowed to reconcile to IFRS-IASB rather than U.S. GAAP if the registrant is a foreign private issuer that uses IFRS-IASB. This will provide investors with more comparable information and avoid a one-time presentation of the U.S. GAAP reconciling information in Rule 3-05 Financial Statements of the target.

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 not material to the registrant as well as *pro forma* financial information that does not fully depict the aggregate effect of the "individually insignificant businesses."

The amendments still require *pro forma* financial information depicting the aggregate effects of all such acquisitions that together exceed 50% significance, but historical financial statements only will be required for those businesses whose individual significance exceeds 20% (but are not yet required to file financial statements). Commenters expressed concern that auditors may be reluctant to provide negative assurance to underwriters on the combined *pro forma* financial information where historical financial statements included in the *pro forma* financial information for individually insignificant acquisitions have not been reviewed or audited. The SEC acknowledged the concern, but stated that while auditors may need to perform additional steps to meet its "reasonable care" and "reasonable investigation" standards, these additional steps do not outweigh the need to simplify and improve the usefulness of information provided to investors.

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 adjusted for certain items provided specified criteria are met. The current rule permits balance sheet adjustments only if they are directly attributable to the transaction and are factually supportable. In the income statement, any adjustments also must be expected to have a continuing impact on the registrant.

The amendments will replace the existing adjustment criteria with simplified requirements, creating two categories of mandatory *pro forma* adjustments: (i) Transaction Accounting Adjustments and (ii) Autonomous Entity Adjustments. These new adjustment categories are required to be presented in separate columns after the presentation of the combined historical information of the registration. Additionally, the amendments recognize a category of Management's Adjustments, which a registrant may elect to present in the notes to the *pro forma* financial information, if certain requirements are met.

Transaction Accounting Adjustments and Autonomous Entity Adjustments

Transaction Accounting Adjustments will depict, in the *pro forma* balance sheet and income statement, the required accounting (GAAP or, if applicable, IFRS-IASB) of the acquisition, disposition or other transaction. Autonomous Entity Adjustments are adjustments necessary 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

Management's Adjustments may be included to depict the synergies and dis-synergies identified by management in determining to consummate or integrate a transaction. Management's Adjustments may include forward-looking information, such as the anticipated effects of closing facilities, discontinuing product lines, terminating employees, executing new agreements or modifying existing agreements. Such disclosures benefit from a safe harbor and highlight for investors the potential effects of the acquisition and the post-acquisition plans to be undertaken by management.

Each Management's Adjustment must meet certain criteria, including that:

- there is a reasonable basis for the adjustment;

- the adjustment is 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 as if the synergies and dis-synergies existed as of the beginning of the fiscal year presented. If such adjustments reduce expenses, the reduction shall not exceed the amount of the related expense historically incurred during the *pro forma* period presented; and
- 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. When synergies are presented, any related dis-synergies also shall be presented.

Further, Management's Adjustments must meet certain presentation criteria, including:

- Management's Adjustments must be presented in the explanatory notes to the *pro forma* financial information in the form of reconciliations of *pro forma* net income from continuing operations attributable to the controlling interest and the related *pro forma* earnings per share data to such amounts after giving effect to Management's Adjustments;
- Management's Adjustments included or incorporated by reference into a registration statement, proxy statement, offering statement or Form 8-K should be as of the most recent practicable date prior to the effective date, mail date, qualified date or filing date, as applicable, which may require that they be updated even if previously provided in a Form 8-K that is appropriately incorporated by reference;
- If Management's Adjustments will change the number of shares or potential common shares, the change must be reflected within Management's Adjustments in accordance with U.S. GAAP or IFRS-IASB, as applicable, as if the common stock or potential common stock were outstanding as of the beginning of the period presented (*i.e.*, the number of shares used in the calculation of the *pro forma* per share amounts must be based on the weighted average number of shares outstanding during the period adjusted to give effect to the number of shares issued or to be issued to consummate the transaction, or, if applicable, whose proceeds will be used to consummate the transaction as if the shares were outstanding as of the beginning of the period presented); and
- The explanatory notes must also include disclosure of the basis of calculation and any material limitations for each adjustment. Registrants also should disclose material assumptions; uncertainties; an explanation of the method of calculation, if material; and the estimated time for achieving the synergies and dis-synergies disclosed.

The final rules make clear that any forward-looking statements contained in Management's Adjustments will benefit from safe harbor protections in Securities Act 175 and Exchange Act 3b-6.

Other Changes

In addition to the changes described above, the SEC also adopted a variety of smaller changes. While this alert does not cover these in detail, some of the more notable changes include the following.

Real Estate Operations

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

Smaller Reporting Companies

The amendments make corresponding changes to the smaller reporting company requirements in Article 8 of Regulation S-X. Rule 8-05 has been revised to require that the preparation, presentation and disclosure of *pro forma* financial information by smaller reporting companies substantially complies with Article 11. Rule 8-04 has been revised to direct registrants to Rule 3-05 for the requirements relating to the financial statements of businesses acquired or to be acquired, other than for form and content requirements for such financial statements, which would continue to be prepared in accordance with Rules 8-02 and 8-03. Because Part F/S of Form 1-A refers to Rule 8-05, the revisions to Rule 8-05 apply to issuers relying on Regulation A.

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