

Clients & Friends Memo

SEC Adopts Amendments to Disclosure Requirements for Acquired and Disposed Businesses

May 29, 2020

On May 21, 2020, the Securities and Exchange Commission (the “**SEC**”) adopted amendments to its disclosure requirements for acquired and disposed businesses. The amendments, which are effective January 21, 2021 (the “**Amendments**”), are intended to assist registrants in making more meaningful determinations of whether an acquired or disposed business or subsidiary is significant, reduce the complexity and burden of producing required financial information in connection with acquisitions and dispositions and improve the quality of financial information for investors. Registrants may elect to voluntarily comply with the Amendments in advance of January 21, 2021.

The material changes to existing disclosure requirements resulting from the Amendments include:

- the incorporation of market capitalization in the investment test and a revenue component in the income test to better determine the significance of an acquisition or disposition;
- the alignment of significance thresholds for disposed businesses to those used for acquired businesses;
- the requirement that historical financial statements for significant acquisitions cover only up to the two most recent fiscal years and the ability to use abbreviated financial statements in certain situations;
- the replacement of existing pro forma financial information adjustment criteria to clarify accounting adjustments and provide registrants the option to articulate the synergies and dis-synergies of an acquisition or disposition;
- the removal of the requirement that historical financial statements of acquired businesses be included in registration statements and proxy statements in certain situations, even after an acquired business is reflected in a registrant’s consolidated financial statements; and
- the ability for foreign private issuers to reconcile financial statements of foreign businesses to IFRS-IASB in lieu of U.S. GAAP in certain situations.

The Amendments also include conforming changes to improve consistency across rules and forms and generally conform and update rules which the SEC noted had not previously been comprehensively reevaluated since their adoption over 30 years ago, including with respect to industry specific oil and gas producing activities and real estate operations as well as conforming changes to disclosure obligations applicable to smaller reporting companies under Article 8 of Regulation S-X.

Significance

Under SEC rules, including Rule 3-05 of Regulation S-X addressing required financial statements of acquired businesses, the definition of “significant subsidiary” under Rule 1-02(w) of Regulation S-X is used to determine whether an acquired or disposed business is significant for a registrant, thereby triggering certain disclosure requirements. Under Rule 1-02(w) of Regulation S-X, a “significant subsidiary” is one that meets one of three tests which are generally referred to as the Investment Test, the Income Test and the Asset Test. If an acquisition is significant, certain historical financial statements of the acquired business are required. If an acquisition meets certain higher thresholds of significance, financial statements for additional periods are required to be disclosed. The Amendments revise the Investment Test and the Income Test and include additional conforming changes to ensure the thresholds are applied consistently, including conforming threshold levels for dispositions to those used for acquisitions.

Investment Test

The Investment Test is generally a comparison of the registrant’s and its other subsidiaries’ investments in and advances to the tested subsidiary to the total assets of the registrant and its subsidiaries. As amended, “total assets” of the registrant for purposes of the Investment Test will be replaced with the average daily aggregate worldwide market value of the registrant’s voting and non-voting common equity for the last five trading days of the most recently completed month prior to announcement of the acquisition or disposition. In the event the registrant does not have an aggregate worldwide market value, or to the extent an SEC rule outside of the acquisition or disposition context applies the Investment Test, the existing comparison of “total assets” will be retained.

The SEC noted that the Amendments were adopted to provide for a more meaningful comparison given that “investments in” the tested subsidiary generally consists of the consideration or purchase price paid and a registrant’s aggregate worldwide market value is a more objective measure, determined by the public markets. When determining the significance of a disposed business under the Investment Test, “investments in” the tested business will equal the fair value of the consideration. In the event the registrant does not have an aggregate worldwide market value and “total assets” is used for comparison purposes, “investments in” the tested business will equal the carrying value of the disposed business.

The Amendments also clarify that for purposes of acquisitions, “investments in” a tested subsidiary includes contingent consideration. To the extent required under U.S. GAAP or IFRS-IASB, as applicable, such contingent consideration shall be recognized at fair value. In the event recognition at fair value is not required under U.S. GAAP or IFRS-IASB, as applicable, all contingent consideration will be included in “investments in” except to the extent the likelihood of payment is remote. The SEC noted that contingent consideration can be a material component of the total consideration paid and inclusion of contingent consideration provides a more accurate measure of the relative significance of a business.

Income Test

The Income Test is generally a comparison of the registrant’s equity in the tested subsidiary’s income from continuing operations before income taxes (exclusive of amounts attributable to noncontrolling interests) to the registrant’s income from continuing operations, in each case for the most recently completed fiscal year. As amended, a revenue component was added to the Income Test whereby the registrant’s and its other subsidiaries’ proportionate share of the tested subsidiary’s consolidated total revenues (after intercompany eliminations) are compared to the registrant’s consolidated total revenues.

To satisfy the Income Test under the Amendments, a tested subsidiary must meet both the income component and the revenue component, to the extent the revenue component is applicable. The revenue component will not apply in the event either of the registrant and its subsidiaries or the tested subsidiary did not have material revenue in each of the two most recently completed fiscal years. While the SEC did not provide additional clarification on “material revenue”, the Amendments noted that in response to several comments the SEC adopted this language, in lieu of “recurring annual revenue” as originally proposed, to aid registrants in applying the revenue component to the Income Test.

For purposes of determining the level of significance and required financial statements under Rule 3-05 of Regulation S-X, to the extent the revenue component is applicable, a registrant may use the lower of the income component and revenue component to ascertain the number of periods of financial statements required. The SEC noted that the Amendments were adopted in response to comments that the current Income Test results in anomalous significance results for some registrants with marginal or break-even net income or loss. Purchasers will now be able to use revenue as an indicator of significance which should help reduce the likelihood that a potentially insignificant acquisition will be deemed “significant” for purposes of Rule 3-05 of Regulation S-X.

Significance of Disposed Businesses

Another intended goal of the Amendments was to conform significance thresholds for disposed businesses to those used for acquired businesses. In furtherance of this, the SEC raised the lowest significance level for dispositions under Rule 11-01(b) to 20% (from 10%), which conforms to the level of significance used in connection with an acquisition under Rule 3-05 of Regulation S-

X and should better align disclosure obligations for a selling party and acquiring party. Registrants that engage in a sale transaction will be able to employ the same tests and determinations, to the extent applicable, as the registrant would in the context of an acquisition which, as noted by the SEC, will improve consistency and create more uniform disclosure.

Required Financial Statements

The Amendments revise the duration and scope of required financial statements both for registrants and acquired and disposed businesses. The Amendments reduce the maximum number of periods for which historical financial statements of an acquired business are required and also permit registrants to omit certain financial information for acquired businesses in certain situations as well as eliminate the burden of including historical financial statements for acquired businesses after such businesses have already been reflected in a registrant's consolidated financial statements for a minimum period.

Periods Required

The Amendments reduce from three years to two years the maximum number of years of audited and unaudited financial statements that a registrant must include for an acquired business under Rule 3-05 of Regulation S-X and permit abbreviated financial statements in certain circumstances.

The SEC noted that unlike historical financial statements of the registrant, the financial statements required under Rule 3-05 of Regulation S-X are intended to help investors evaluate how an acquired business will affect the registrant's consolidated operations and the benefit of requiring audited financial statements which are three years old is not likely to outweigh the burden of preparing and auditing such statements. In the adopting release, the SEC also noted that to the extent three-year-old financial statements would otherwise be informative in a particular instance, Rule 4-01(a) still requires a registrant to provide "such further material information as is necessary to make the required statements, in light of the circumstances under which they are made, not misleading."

Abbreviated Financial Statements

As amended, Rule 3-05(e) of Regulation S-X will also permit registrants that acquire certain significant businesses to provide audited abbreviated financial statements of the acquired business if certain presentation requirements are met. Such abbreviated financial statements may consist of statements of assets acquired and liabilities assumed and statements of revenues and expenses (which may exclude corporate overhead, interest and income tax expenses). A registrant will be permitted to provide abbreviated financial statements if:

- the total assets and total revenues (both after intercompany eliminations) of the acquired business constitute no more than 20% 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 or division during the period for which financial statements would be required;
- separate financial statements for the acquired business have not previously been prepared; and
- the seller has not maintained separate accounts necessary to prepare unabbreviated financial statements.

Pro Forma Financial Statement Adjustment Criteria

As amended, Article 11 of Regulation S-X will include three categories of pro forma adjustment criteria, including:

- “Transaction Accounting Adjustments”, which are required adjustments to reflect only the application of required accounting to the transaction. Registrants must include the accounting for the transaction required by U.S. GAAP or IFRS-IASB, as applicable, in the pro forma condensed balance sheet and the effects of such balance sheet adjustments in the pro forma condensed income statements, assuming such adjustments were made at the beginning of the fiscal year presented.
- “Autonomous Entity Adjustments”, which are required adjustments necessary to reflect the operations and financial position of the registrant as an autonomous entity. To the extent the registrant was previously part of another entity under Rule 11-01(a)(7) of Regulation S-X, registrants must include the necessary adjustments in a separate column from other adjustments; and
- “Management Adjustments”, which are optional adjustments to depict the synergies and dis-synergies identified by management in determining to consummate the transaction. Unlike Transaction Accounting Adjustments and Autonomous Entity Adjustments, Management Adjustments are not required but are intended to provide registrants flexibility and may be presented if, in “management’s opinion, such adjustments would enhance an understanding of the pro forma effects of the transaction.”

The SEC adopted these amendments to the pro forma financial information requirements to improve the content and relevance of such information and simplify and clarify the requirements.

Registration Statements and Proxy Statements

As part of the Amendments, the SEC eliminated the requirement to include financial statements required by Rule 3-05 of Regulation S-X in registration statements and proxy statements once an acquired business is reflected in the filed financial statements of the registrant for at least nine months or one year, dependent on the level of significance of the acquisition. The SEC recognized the likely diminished value to investors of an acquired business’ historical financials after such business has already been reflected in an acquirer’s consolidated financial statements as well as

the increased burden and time to prepare such financial statements and delays such preparation has on a registrant's access to capital.

Use of Pro Forma Financial Statements for Subsequent Acquisitions

The Amendments also codify practices which the SEC noted may have already been applied by registrants. For instance, the Amendments make clear that a registrant that has acquired or disposed of a significant business after the date of the latest fiscal year-end financial statements for such registrant may, in certain situations, use pro forma financial statements, as opposed to historical financial information, to evaluate and determine the significance of a subsequently acquired business.

Foreign Private Issuers

The Amendments also revise Rule 3-05(c) of Regulation S-X to permit foreign private issuers that prepare their financial statements using IFRS-IASB to reconcile financial statements of certain foreign businesses to IFRS-IASB in lieu of U.S. GAAP. To the extent an acquired foreign business has historically prepared its financial statements using home country GAAP instead of IFRS-IASB or U.S. GAAP, the Amendments will now permit a foreign private issuer to reconcile such statements to IFRS-IASB if such registrant's consolidated financial statements are prepared using IFRS-IASB and not U.S. GAAP.

In the adopting release, the SEC noted the inconsistency under the current rules of requiring foreign private issuers to prepare financial statements for acquired businesses using U.S. GAAP when none of their other financial statements are required to be prepared using U.S. GAAP. The SEC added that it adopted the Amendments to maintain uniform financial statements and no longer requires foreign private issuers to bear the expense of preparing one-time U.S. GAAP financial statements for Rule 3-05 of Regulation S-X when such financial statements are not required for such issuers under other SEC rules.

Carve-Out Transactions

The SEC expressly provided that the Amendments do not address what disclosures and financial statements are required in connection with carve-out transactions adding that "issues relating to carve-out financial statements may require unique judgments" and are best addressed "through the staff consultation process." While the Amendments generally help to guide disclosure obligations for sellers and purchasers, registrants may have less clarity going forward in the event of a carve-out transaction and should evaluate such transactions on a case-by-case basis.

The SEC's press release and fact sheet are available [here](#). The adopting release is available [here](#).

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If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

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