SEC PROPOSES SIMPLIFIED FINANCIAL DISCLOSURES RELATING TO ACQUISITIONS AND DISPOSITIONS OF BUSINESSES

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On May 3, 2019, the U.S. Securities and Exchange Commission proposed amendments to its rules and forms to simplify the disclosure requirements for financial statements relating to acquisitions and dispositions of businesses. Specifically, the SEC proposed amendments to the financial disclosure requirements in Rule 3-05 (Financial Statements of Businesses Acquired or to Be Acquired), Rule 3-14 (Special Instructions for Real Estate Operations to Be Acquired), and Article 11 (Pro Forma Financial Information) of Regulation S-X, as well as related rules and forms. The SEC also proposed a new Rule 6-11 of Regulation S-X and amendments to Form N-14 for financial reporting of acquisitions involving investment companies. The proposed amendments would, if implemented, improve for investors the financial information about acquired or disposed businesses, facilitate more timely access to capital, and reduce the complexity and costs to prepare the disclosure.

The SEC is soliciting public comment on the proposed amendments for 60 days after its publication in the Federal Register.

Background

Under Rule 3-05, when a company acquires a significant business, other than a real estate operation, the acquiring company must provide separate audited annual and unaudited interim pre-acquisition financial statements for the acquired business. The number of years of financial information that must be provided depends on the relative significance of the acquisition to the acquiring company. Whether an acquisition is significant under Rule 3-05 is determined by applying the investment, asset, and income tests provided in the “significant subsidiary” definition in Rule 1-02(w) of Regulation S-X.
Similarly, with respect to real estate operations, Rule 3-14 requires a company that has acquired a significant real estate operation to file financial statements with respect to such acquired operation.

Article 11 also generally requires companies to file unaudited pro forma financial information showing the impact of the acquisition or disposition to the acquiring company’s balance sheet and income statements.

The required financial statements and pro forma financial information generally must be filed within 75 days after consummation of the acquisition under Form 8-K and, for non-real estate acquisitions, in certain registration statements and proxy statements.

**Summary of Proposed Amendments: Acquired Business Financial Statements Generally**

**Significance Tests**

The proposed amendments would revise the tests that are used to determine the significance of a business acquisition or disposition by modifying the “investment test” and the “income test.” The proposed amendments are intended to more accurately reflect the relative significance to the acquiring company of the acquired business and to reduce anomalous results in the application of the definition of “significant subsidiary.” The proposed amendments leave the “asset test” unchanged.

- **Investment Test.** Under current rules, the investment test compares the acquiring company’s investment in the acquired business to the value of the acquiring company’s total assets. The revised investment test would instead compare an acquiring company’s investment in the acquired business to the “aggregate worldwide market value” of the acquiring company’s common equity, if available. If the acquiring company’s common equity does not have an aggregate worldwide market value, the current investment test would continue to apply.

- **Income Test.** Under current rules, the income test focuses on one component, net income (or income from continuing operations before taxes). The proposed amendments would revise the income test to add a new revenue component. The revised income test would require that, if the acquiring company and the acquired business have recurring annual revenue, the acquired business must meet both the new revenue component and the net income component. This revised income test is intended to more accurately determine whether a business is significant to the acquiring company and to reduce the frequency of “anomalous results that may occur by relying solely on net income.” The proposed amendments would also simplify the calculation of net income by using income or loss from continuing operations after income taxes, which would permit the acquiring company to “use line item disclosure from its financial statements, simplifying the determination.”

**Acquired Business Audited Financial Statements**

The current rules require up to three years of audited financial statements for the acquired business if significance exceeds 50%. The proposed amendments would reduce this requirement to two years. In addition, if a significance test exceeds 20%, but not 40%, the proposed amendments would require financial statements for the “most recent” interim period rather than “any” interim period and eliminate the need to provide a comparative interim period when only one year of audited financial statements is required.

**Financial Statements for Component Acquisitions**

When an acquiring company acquires a component of an entity, such as a product line or a line of business that constitutes a “business” for financial reporting purposes, the selling entity may be unable to provide financial statements for the acquired component. In addition, it may be impracticable for the selling entity to allocate its corporate overhead, interest and income tax expenses for purposes of providing such financial statements. To address these issues, the proposed amendments would permit acquiring companies to provide audited financial statements of assets acquired and liabilities assumed, and statements of revenues and expenses that exclude corporate overhead, interest and income tax expenses, if certain conditions are satisfied.

**Foreign Businesses**

The current rules permit the use of IFRS-IASB without reconciliation to U.S. GAAP in financial statements of foreign private issuers and permit the use of IFRS-IASB in financial statements of foreign businesses. The proposed amendments would permit 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 an SEC registrant, and to permit foreign private issuers that prepare...
their financial statements using IFRS-IASB to provide financial statements prepared using home country GAAP to be reconciled to IFRS-IASB rather than U.S. GAAP.

Clarifying Language

The proposed amendments would revise the current rules to clarify when financial statements and pro forma financial information are required.

Acquired Business Financial Statements in Registration and Proxy Statements

Omission of Acquired Business Financial Statements

The current rules permit financial statements of an acquired business to be omitted once the operating results of the acquired business have been reflected in the audited consolidated financial statements of the acquiring company for a complete fiscal year, unless the financial statements of the acquired business have not been filed or, if filed, the acquired business is of major significance. Under the proposed amendments, financial statements would no longer be required in registration statements and proxy statements once the acquired business is reflected in filed post-acquisition financial statements for a complete fiscal year, eliminating the requirement to provide financial statements of the acquired company when they have not been filed or when they have been filed but the acquired business is of major significance.

Use of Pro Forma Financial Information to Test Significance

Under the current rules, significance determinations must be made by comparing the most recent annual consolidated financial statements of the acquired business to those of the acquiring company filed at or prior to the date of acquisition. An acquiring company may only use pro forma, rather than historical, financial information if the company made a significant acquisition subsequent to the latest fiscal year-end and filed its financial statements and pro forma financial information on Form 8-K. The proposed amendments would expand the circumstances in which an acquiring company can use pro forma financial information for significance testing, allowing the acquiring company to measure significance using filed pro forma financial information that only depicts significant business acquisitions and dispositions consummated after the latest fiscal year-end for which the company’s financial statements are required to be filed, if certain conditions are satisfied.

Individually Insignificant Acquisitions

The current rules provide that if the aggregate impact of “individually insignificant businesses” acquired since the date of the most recent audited balance sheet exceeds 50%, an acquiring company must include audited historical financial statements covering at least the “substantial majority” of the businesses acquired, as well as related pro forma financial information, in a registration statement or a proxy statement. The proposed amendments would still require acquiring companies to provide pro forma financial information depicting the aggregate effects of all such businesses. However, historical financial statements would not be required to cover a “substantial majority” of the business acquired, but rather only those acquired businesses whose individual significance exceeds 20%.

Pro Forma Financial Information

Adjustment Criteria and Presentation Requirements

Under current rules, pro forma financial information typically includes a pro forma balance sheet and pro forma income statements based on the historical financial statements of the acquiring company and the acquired or disposed business. The pro forma balance sheet may reflect adjustments that are directly attributable to the transaction and factually supportable, regardless of whether they are expected to have a continuing impact on the company. However, the pro forma income statement may only reflect adjustments that are directly attributable to the transaction, expected to have a continuing impact on the company, and factually supportable.

The proposed amendments would replace the existing pro forma adjustment criteria with simplified requirements to reflect the accounting for the transaction and “present the reasonably estimable synergies and other transaction effects that have occurred or are reasonably expected to occur.” Specifically, the proposed adjustments would be broken into the following two categories:

- **Transaction Accounting Adjustments.** These adjustments would depict in the pro forma balance sheet and pro forma income statement the accounting for the transaction required by U.S. GAAP or IFRS-IASB.
- **Management’s Adjustments.** These adjustments would be “required for and limited to 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 rea-
sonably estimable and have occurred or are reasonably expected to occur.” For information where synergies and other transaction effects are not reasonably estimable, companies would be required to provide qualitative disclosure of such information in the explanatory notes to the pro forma financial information.

**Significance and Business Dispositions**

Under current rules, pro forma financial information is required upon the disposition of a significant portion of a business, if that disposition is not fully reflected in the financial statements of the selling company. The current rules further provide that a disposition of a business is significant if the disposed business meets the conditions of a significant subsidiary using a 10% significance threshold, not the 20% threshold used for business acquisitions.

The proposed amendments would raise the significance threshold for a disposed business from 10% to 20% to conform to the significance threshold for an acquired business and also conform, as applicable, the tests used to determine significance of a disposed business to those used to determine significance of an acquired business.

**Real Estate Operations**

Currently, Rule 3-14, which applies to the financial statements of real estate operations acquired or to be acquired, differs from Rule 3-05 due to unique real estate industry considerations that warrant different disclosure. The proposed amendments would generally align Rule 3-14 with the proposed amendments to Rule 3-05 described above. The proposed amendments would also clarify the application of Rule 3-14 with respect to significance determinations, interim financial statement requirements and other matters.

**Investment Companies**

The proposed amendments would add a definition of significant subsidiary in Regulation S-X specifically tailored for investment companies, and would add a new Rule 6-11, modeled after the proposed amendments to Rule 3-05 and 3-14 described above, to address the financial statements of acquired investment funds. The proposed amendments would also replace the pro forma financial information requirement currently applicable to investment companies with a requirement to provide supplemental financial information about the newly combined entity. Finally, the proposed amendments would amend Form N-14 so that its disclosure requirements are consistent with the disclosures required in proposed Rule 6-11.

**ENDNOTES:**