

SEC Proposes Changes to Financial Disclosures About Acquired and Disposed Businesses

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On May 3, 2019, the Securities and Exchange Commission (SEC) proposed changes to its financial statement disclosure requirements for acquisitions and dispositions of businesses under Rule 3-05 and other rules in Regulation S-X. The main goals of these changes are to improve the financial information about these acquired or disposed businesses, facilitate more timely access to capital, and reduce the complexity and costs involved in preparing the required financial disclosures. The proposed amendments are part of the SEC's ongoing, comprehensive evaluation of its disclosure rules and follow its 2015 request for comment that sought feedback on, among other things, financial disclosure requirements for entities other than the registrant. The comments received in that process were considered in developing the proposed amendments. A copy of the proposed rules is available [here](#).

For public companies, registered investment companies and business development companies that acquire other businesses, the SEC rules currently require audited and unaudited financial statements of the acquired business if the business is considered "significant" under any one of three tests: the Investment Test, the Asset Test or the Income Test, which refer to the definition of "significant subsidiary" in Regulation S-X. The amount of financial disclosure required is on a sliding scale, depending on the level of significance the acquired business represents, relative to the acquiring company, under those tests.

The proposed amendments would:

- Amend the significance tests by revising the Investment Test and the Income Test, expanding the permitted use of pro forma financial information in applying the significance tests and conforming the significance tests and thresholds for disposed businesses;
- Limit the maximum number of years of audited financial statements of the acquired business required to the two most recent fiscal years and, in certain cases, eliminate the need for comparable prior-year information when unaudited interim period financial statements are provided;
- Amend the pro forma financial information requirements to enhance the content and relevance of the information;
- No longer require separate acquired business financial statements once the acquired business has been included in the registrant's post-acquisition financial statements for a full fiscal year;

- Expand the permitted use of or reconciliation to International Financial Reporting Standards, as issued by the International Accounting Standards Board (“IFRS-IASB”);
- For an acquisition of a business that is a component of an entity, permit omission of certain expenses in the financial statements presented;
- Conform the rules for acquisitions of real estate operations with the general rules where no unique industry considerations exist;
- Codify existing accommodations for acquisitions of oil and gas producing operations that permit presentation of abbreviated financial statements excluding certain expenses not comparable to future operations; and
- Introduce new financial disclosure requirements specifically tailored for registered investment companies to address their unique attributes.

Changes to Significance Tests

The significance tests for disclosures of acquired and disposed businesses refer to the definition of “significant subsidiary” in Section 1-02(w) of Regulation S-X. The proposed amendments would amend the definition of “significant subsidiary” to revise the Investment Test and the Income Test, but would leave the Asset Test unchanged. These amendments would also impact the other disclosure requirements that refer to the “significant subsidiary” definition, such as disclosures in periodic reports under the Exchange Act and exhibits that are required to list a company’s significant subsidiaries, among others. The SEC believes that maintaining the consistency of the significance determination across the different disclosure requirements will avoid unnecessary regulatory complexity.

Investment Test

The current Investment Test compares the acquiring company’s investments in and advances to the acquired business to the total assets of the acquiring company, as shown on its most recent annual financial statements required to be filed on or before the acquisition date. The proposed changes to the Investment Test would compare the acquiring company’s investment in and advances to the acquired business to the aggregate worldwide market value (when available) of the acquiring company’s common equity (both voting and non-voting). If the acquiring company does not have an aggregate worldwide market value, the existing test based on total assets would continue to apply. The SEC believes that using the aggregate worldwide market value would better align the Investment Test with the economic significance of the business acquisition to the acquiring company because the total assets may not fully reflect the company’s fair value.

Income Test

The current Income Test compares the acquiring company’s equity in the income from continuing operations of the acquired business before income taxes, exclusive of amounts attributable to any noncontrolling interests, to the same measure of the acquiring company, as shown on its most recent annual financial statements required to be filed on or before the acquisition date. The Income Test, as currently applied, focuses exclusively on net income, which may not always be the best indicator of performance, because it can include infrequent expenses, gains or losses that can distort the determination of relative significance. Relatively small acquisitions by companies with small net income or loss or break-even performance, which may not be considered material to investors, can often trigger disclosure requirements based on the Income Test, due to the exclusive focus on net income. The SEC staff frequently receives requests for relief from the disclosure requirements by companies in this situation.

The proposed amendments would add a new revenue component and simplify the net income component by using the income or loss from continuing operations after income taxes line item. Under the amended Income Test, where both the acquiring company and the acquired business have recurring annual revenue, the acquired business would be required to meet both the revenue and net income components of the test to be significant, using the lower of the revenue or net income component to determine the number of periods for which financial statements

are required. If either the acquiring company or the acquired business does not have recurring annual revenue, only the net income component would apply.

The proposed amendments would use absolute values in calculating net income and average net income when either the acquiring company or the acquired business, but not both, has a net loss. For calculating average net income, using the absolute value departs from the current SEC staff interpretation, which indicates that zero should be used for loss years.

Use of Pro Forma Financial Information to Measure Significance

Currently, a registrant is permitted to use pro forma financial information in applying the significance tests only if it made a significant acquisition subsequent to the most recent fiscal year end and has filed the required acquired business financial statements and pro forma financial information. No comparable provisions permit use of pro forma financial information for applying the significance tests for dispositions.

The proposed amendments would permit registrants to measure significance using filed pro forma financial information that presents significant business acquisitions or dispositions consummated after the latest fiscal year end for which financial statements are required to be filed, provided that the registrant has filed the required acquired business financial statements and pro forma financial information for any such acquired or disposed business. However, the pro forma financial information used to determine significance may not include Management's Adjustments to the pro forma financial information, only the Transaction Accounting Adjustments (discussed below under "Revised Pro Forma Financial Information Requirements").

Conform Significance Thresholds for Acquisitions and Dispositions

Currently, the significance threshold for inclusion of pro forma financial information under Article 11 of Regulation S-X is 20% for acquired businesses but only 10% for disposed businesses. The proposed amendments would harmonize the significance thresholds to 20% for both significant acquisitions and dispositions.

Reduce Number of Years of Audited Financial Statements Required

Under the current rules, up to three years of audited financial statements of the acquired business may be required, depending on the level of significance determined by the significance tests. The proposed amendments would eliminate the requirement to provide the third year of audited annual financial statements for acquisitions exceeding the 50% significance threshold and, therefore, limit the disclosure requirements to two years of audited financial statements for all acquisitions exceeding the 40% significance threshold. In addition, for acquisitions exceeding the 20% significance threshold, but below the 40% threshold, the proposed amendments would effectively eliminate the requirement to provide comparative prior-year interim period financial statements where only one year of audited annual financial statements are required.

Omission of Financial Statements for Businesses Included in a Registrant's Financial Statements for a Full Fiscal Year

Currently, if an acquired business has been included in an acquiring company's post-acquisition financial statements for one complete fiscal year, the company does not need to provide separate acquired business financial statements in its SEC filings, except:

- when the company has not previously filed such financial statements; or
- when the financial statements were previously filed, but the acquired business is of "major significance" to the acquiring company, such that the omission of the financial statements would materially impair the ability of investors to understand the historical financial results of the acquiring company.

The proposed amendments would eliminate the exceptions described above and would no longer require financial statements of acquired businesses if they are reflected in the acquiring company's post-acquisition financial statements for a complete fiscal year. The SEC believes that inclusion of post-acquisition results in the registrant's audited financial statements for a complete fiscal year should provide investors with sufficient information to make an informed investment decision about the registrant.

These proposed changes have a particular impact on registrants that are foreign private issuers or first-time registrants, such as those engaging in IPOs or A/B exchange offers, that have not previously been subject to Form 8-K filing requirements. Unlike domestic filers, which are required to provide the acquired business financial statements on Form 8-K within 75 days after completion of an acquisition, foreign private issuers do not have a comparable requirement under the Exchange Act. As a result, foreign private issuers are generally not required to file separate acquired business financial statements and pro forma financial information until the filing of a registration statement under the Securities Act, which may occur long after the completion of the acquisition. Similarly, first-time registrants also may be filing their initial registration statements long after completion of the acquisition. The proposed amendments would relieve these foreign private issuers and first-time registrants of the burden of providing the acquired business financial statements if the acquired business has been included in the audited financial statements for at least a complete fiscal year, and would allow them to avoid the associated cost and potential delay to their offerings and facilitate their access to capital.

Revised Pro Forma Financial Information Requirements

Article 11 of Regulation S-X sets forth the requirements for pro forma financial information that is required to accompany acquired business financial statements for significant acquisitions or to reflect dispositions of significant businesses. The proposed amendments would revise the pro forma adjustment criteria to separately show the effects of the accounting for the transaction and to present the reasonably estimable synergies and other transaction effects that have occurred or are reasonably expected to occur. As amended, the pro forma adjustments would fall into two categories, which would be presented in separate columns in the pro forma presentation:

- "Transaction Accounting Adjustments" would show in the pro forma balance sheet, the accounting for the transaction required by U.S. GAAP or IFRS-IASB and, in the pro forma income statement, the effects of those adjustments, assuming the adjustments were made at the beginning of the fiscal year presented.
- "Management's Adjustments" would provide flexibility to include forward-looking information that shows the synergies and other transaction effects identified by management that are reasonably estimable and have occurred or are reasonably expected to occur, such as closing facilities, discontinuing product lines, terminating employees, and executing new or modifying existing agreements. Management's Adjustments would be presented in a separate column after the column showing the combined historical financial information and the Transaction Accounting Adjustments.

In addition, the proposed amendments would require specified disclosure in the notes to the pro forma financial information, as well as qualitative disclosure of synergies or other transaction effects that are not reasonably estimable and will not be included in Management's Adjustments, to provide a fair and balanced presentation of the pro forma information.

Expanded Permitted Use of IFRS-IASB

When preparing financial statements for SEC filings, registrants that are foreign private issuers and acquired businesses that are foreign businesses are currently able to use IFRS-IASB without the need to reconcile them to U.S. GAAP. However, certain acquired businesses that would otherwise qualify as foreign private issuers may not meet the definition of a foreign business and are not currently permitted to use IFRS-IASB without reconciliation to U.S. GAAP.

The proposed amendments would permit an acquired business to provide financial statements prepared in accordance with IFRS-IASB without reconciliation if it would qualify to use IFRS-IASB without reconciliation as a

foreign private issuer, if it were a registrant. The proposed amendments would also allow acquiring companies that are foreign private issuers that currently use IFRS-IASB to prepare their financial statements to reconcile financial statements of acquired businesses prepared in accordance with home-country GAAP to IFRS-IASB, rather than reconciling to U.S. GAAP.

These changes should reduce the burdens on foreign acquired businesses and foreign private issuer acquirers to reconcile financial statements to U.S. GAAP when they are already prepared in accordance with IFRS-IASB or can more readily be reconciled to IFRS-IASB.

Financial Statements for Net Assets Constituting a Business

In many instances, an acquiring company acquires not an entire entity, but only a portion of it, such as a product line of another company. Under SEC rules, a product line may be considered a “business” under Rule 3-05, which could trigger the requirement to provide financial statements of the acquired business. However, because they are not separate entities, subsidiaries or divisions, these businesses may not have separate financial statements or maintain separate and distinct accounts necessary to prepare the required financial statements. In these situations, making the allocations of the seller’s corporate overhead, interest and income tax expenses necessary to provide the full financial statements of the business may be impracticable.

The proposed amendments would allow acquiring companies to provide audited financial statements of assets acquired and liabilities assumed, and statements of revenues and expenses (exclusive of corporate overhead, interest and income tax expenses) under certain conditions, provided that the notes to the financial statements include additional disclosures, such as the types of omitted expenses and the reasons for their exclusion.

Other Proposed Amendments for Specific Industries

Conform Rules for Financial Statements of Acquired Real Estate Operations

Due to the nature of real estate transactions, the requirements for financial statements of acquired real estate operations are provided separately in Rule 3-14 of Regulation S-X. However, because the fundamental goals of the general rules under Rule 3-05 and Rule 3-14 are the same, the proposed amendments would align Rule 3-14 with Rule 3-05 where there are no unique industry considerations, including raising the significance thresholds for individual acquisitions to 20% and for the aggregate impact of individual non-significant acquisitions to be over 50% and conforming Rule 3-14 to the other proposed amendments to Rule 3-05. In addition, the proposed amendments would clarify the definition of what is significant, when interim income statements are needed, special provisions for blind pool offerings, and the scope of Rule 3-14’s requirements.

Abbreviated Financial Statements for Oil and Gas Producing Activities

The proposed amendments would codify existing accommodations providing that the required financial statements of significant acquired businesses that include oil and gas producing activities may be audited statements of revenues and expenses that exclude depletion, depreciation, and amortization expense, corporate overhead expense, income taxes, and interest expense that are not comparable to the proposed future operations if substantially all the revenues of the business are generated from oil and gas producing activities and certain specified conditions are met. In addition, the proposed amendments would require that the industry-specific disclosures under FASB ASC Topic 932 “Extractive Activities — Oil and Gas” be included on an unaudited basis for each full year of operations of the acquired business presented.

Rules Specific to Investment Companies

Currently, investment companies, including business development companies, apply the general provisions of Regulation S-X, unless subject to special rules in Article 6. However, investment companies have certain characteristics that differentiate them from non-investment companies. The proposed amendments would tailor the financial reporting requirements for investment companies with respect to acquisitions of investment companies and

other types of funds, for which investment companies frequently have had to consult with the SEC staff on the application of Rule 3-05 and Article 11 to seek relief from their requirements. The proposed amendments would add a definition of significant subsidiary in Rule 1-02(w) that is specifically tailored for investment companies and generally based on Rule 8b-2 under the Investment Company Act. The SEC is also proposing new Rule 6-11, which is modeled on Rules 3-05 and 3-14 as proposed to be amended, to address the financial reporting of fund acquisitions that would apply to the acquisition of another investment company, including a business development company, a private fund and any private account managed by an investment adviser. The proposed amendments would eliminate the requirement to provide pro forma financial information for investment company registrants in connection with fund acquisitions and replace it with supplemental financial information that the SEC believes will be more relevant to investors.

The proposed amendments to the disclosure requirements for acquired and disposed businesses are the latest in a series of changes by the SEC seeking to simplify the required disclosures 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. This effort is within the SEC's overall goal of facilitating more timely access to capital for companies. The proposed amendments address several issues associated with preparing audited financial statements of acquired businesses that acquiring companies have found to be particularly burdensome and costly, as well as other issues that have required registrants to seek accommodations or other relief from the SEC.

Comments on the proposed amendments are due within 60 days after publication of the proposed rules in the Federal Register.

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