

CLIENT ALERT

# SEC Proposes Simplifying Financial Disclosures Relating to Acquisitions and Dispositions

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**AUTHOR**

**Jeffrey S. Hochman**

The Securities and Exchange Commission recently proposed amendments<sup>1</sup> to Regulation S-X and related rules and forms regarding financial disclosure requirements for acquisitions and dispositions of businesses, including real estate operations and investment companies. The proposed amendments aim to simplify and reduce the costs of compliance with respect to such disclosures and thereby facilitate access to capital. The amendments are being proposed pursuant to the SEC's mandate under the 2015 Fixing America's Surface Transportation (FAST) Act,<sup>2</sup> as part of the SEC's ongoing evaluation of the effectiveness of its financial and other disclosure requirements.

The proposed amendments reflect comments submitted in response to the SEC's 2015 request for input on how investors use these disclosures to make investment decisions, the difficulties faced by registrants and others in preparing and providing the required disclosures and suggestions for how to improve the Regulation S-X disclosure framework—specifically, Rules 3-05 and 3-14 and Articles 8 and 11—to promote efficiency, competition and capital formation.<sup>3</sup> The proposed amendments are summarized below.

<sup>1</sup> See SEC Release No. 33-10635, *Amendments to Financial Disclosures about Acquired and Disposed Businesses*, May 3, 2019, available [here](#).

<sup>2</sup> See SEC Release No. 33-10618, *FAST Act Modernization and Simplification of Regulation S-K*, March 20, 2019, available [here](#).

<sup>3</sup> See SEC Release No. 33-9929, *Request for Comment on the Effectiveness of Financial Disclosures About Entities Other than the Registrant*, September 25, 2015, available [here](#).

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### Modifications to Significance Tests

In connection with an acquisition of a business, registrants are generally required, under Rule 3-05 of Regulation S-X, to provide both (i) audited annual financial statements and (ii) unaudited interim pre-acquisition financial statements for the acquired business if it is “significant” to the registrant. To determine whether an acquired business is significant, the SEC requires registrants to apply three tests provided in Rule 1.02(w) of Regulation S-X; an acquired business is determined to be significant if it meets the applicable threshold under *any* of the three tests. The below table summarizes the tests as currently in effect and the SEC’s proposed changes:<sup>4</sup>

<u>Significance Test</u>	<u>Current</u>	<u>As Proposed</u>
<b>Investment Test</b>	<ul style="list-style-type: none"> <li>The registrant’s investment in and improvements to the acquired business are measured against the registrant’s total assets (as reflected in the registrant’s most recent annual financial statements prior to the acquisition)</li> </ul>	<ul style="list-style-type: none"> <li>Measure the registrant’s investment in the acquired business against the registrant’s aggregate equity market value, when available, to better reflect the current significance of the acquired business to the registrant (rather than using historical book value)</li> <li>Use the current test if market value not available</li> </ul>
<b>Asset Test</b>	<ul style="list-style-type: none"> <li>The registrant’s proportionate share of the acquired business’s assets (as reflected in the business’s most recent pre-acquisition annual financial statements) are measured against the registrant’s total assets</li> </ul>	<ul style="list-style-type: none"> <li>No change</li> </ul>
<b>Income Test</b>	<ul style="list-style-type: none"> <li>The pre-tax income of the continuing operations of the acquired business is compared to that of the registrant</li> </ul>	<ul style="list-style-type: none"> <li>Add a revenue test (where the registrant and acquired business have annual recurring revenue) to eliminate anomalous results that may arise from relying exclusively on an income test</li> <li>Revise income test to use <i>post-tax</i> income or loss from the continuing operations of the acquired business</li> <li>Use the <i>lower</i> of these two tests to measure significance</li> </ul>

Under current rules, a registrant is permitted to measure significance using pro forma, rather than historical, financial information when it has made a significant acquisition after the end of its most recent fiscal year and has filed the requisite

<sup>4</sup> The proposed changes in the tests would similarly apply to the definition of “significant subsidiary” under the rules.

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acquired business historical and pro forma financial information. The proposed amendments would expand this rule to cover post-fiscal year end dispositions as well where the requisite financial information has been filed. However, the proposed “Management’s Adjustments” described below would not be permitted to be used in applying these pro forma tests.

### Modifications to Required Historical Financial Statements of the Acquired Business

As summarized below, the SEC proposes to eliminate some of the historical financial statement requirements for significant acquisitions:

<b>Significance</b> (under <i>any</i> of the three tests)	<b>Required Acquired Business Financial Statements</b>	
	<b>Current</b>	<b>As Proposed</b>
Greater than 20% but less than 40%	<ul style="list-style-type: none"> <li>One year of audited financial statements</li> <li>Interim unaudited financial statements for subsequent interim period, together with corresponding prior year interim period</li> </ul>	<ul style="list-style-type: none"> <li>Same, but prior comparative period for interim period not required</li> </ul>
Greater than 40% but less than 50%	<ul style="list-style-type: none"> <li>Two years of audited financial statements</li> <li>Same as above for interim periods</li> </ul>	<ul style="list-style-type: none"> <li>No change</li> </ul>
Greater than 50%	<ul style="list-style-type: none"> <li>Three years of audited financial statements</li> <li>Same as above for interim periods</li> </ul>	<ul style="list-style-type: none"> <li>Audited financial statement requirement reduced to two years</li> </ul>

The proposed amendments would also eliminate any requirement to provide separate financial statements of the acquired business once the results of its operations have been included in the registrant’s audited financial statements for a full fiscal year, including where the financials of the acquired business have not previously been filed (such as in connection with an IPO of the acquirer) or where the significance of the acquired business exceeds the 80% level. The amendments would also conform the significance tests and thresholds applicable to dispositions to those for acquisitions (e.g., increasing the significance threshold for dispositions from the current 10% to 20%).

### Modifications to Required Pro Forma Financial Statements

Under current rules, registrants are required to provide pro forma financial statements (typically, the most recent annual and interim period income statements and the most recent balance sheet) for significant acquisitions and dispositions. To provide greater flexibility with respect to the types of pro forma adjustments allowed, the proposed amendments would create two categories:

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- “*Transaction Accounting Adjustments*,” which would depict (i) the accounting for the transaction required by U.S. Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS), as applicable, in the pro forma condensed balance sheet and (ii) the effects of those pro forma balance sheet adjustments, assuming such adjustments were made as of the beginning of the applicable fiscal year, in the pro forma condensed income statements; and
- “*Management’s Adjustments*,” which would reflect synergies and other forward-looking effects of the transaction that can reasonably be estimated and that have occurred or are reasonably expected to occur, such as closing facilities, discontinuing product lines, terminating employees and modifying contractual agreements.

These two categories of adjustments would be presented in separate columns to distinguish between (i) the accounting effects of the underlying acquired business on the registrant and (ii) the operational effects of the registrant’s management’s plans, which are subject to management’s discretion and other uncertainties.

### Other Proposed Changes

The SEC’s proposed amendments also include the following:

- permitting registrants in connection with certain carve-out acquisitions to provide financial statements of assets acquired and liabilities assumed that omit corporate overhead, interest and certain other unallocated expenses;
- aligning and revising the rules applicable to real estate operations, investment companies and oil and gas operations;
- revising the requirements for individually insignificant acquisitions;
- permitting the use of IFRS rather than GAAP in connection with the preparation of Rule 3-05 financial statements if the acquired business would qualify to use IFRS if it were a registrant;
- making corresponding changes to the smaller reporting company requirements, as set forth in Article 8 of Regulation S-X; and
- making a variety of other conforming changes and updates since the initial adoption of the rules 30 years ago.

The SEC’s release, which contains nearly 100 questions, most with several parts, solicits comments on these proposed amendments to Regulation S-X and related rules and forms for a 60-day period following publication in the Federal Register. In a statement<sup>5</sup> accompanying the proposed amendments, Commissioner Robert J. Jackson, Jr. expressed concern that the proposal could result in less disclosure, particularly in situations where the acquiring company has a market value significantly higher than its book value, where greater transparency is warranted. Registrants, investors and other interested parties are encouraged to express their views on the proposed changes.

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<sup>5</sup> See Robert J. Jackson, Jr., *Statement on Financial Disclosures about Acquired and Disposed Businesses*, May 3, 2019, available [here](#).

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If you have any questions regarding this client alert, please contact the following attorney or the Willkie attorney with whom you regularly work.

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**Jeffrey S. Hochman**

212 728 8592

[jhochman@willkie.com](mailto:jhochman@willkie.com)

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