CLIENT ALERT

SEC Simplifies Financial Disclosures Relating to Acquisitions and Dispositions

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

The amendments take effect on January 1, 2021, but registrants are permitted to voluntarily comply with the rules in advance of the effective date. The amendments are summarized below.

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

[1] See SEC Release No. 33-10786, *Amendments to Financial Disclosures about Acquired and Disposed Businesses*, May 21, 2020, available here.

[2] See SEC Release No. 33-10635, *Amendments to Financial Disclosures about Acquired and Disposed Businesses*, May 3, 2019, available here, and our related client memorandum, SEC Proposes Simplifying Financial Disclosures Relating to Acquisitions and Dispositions, available here.

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 changes:[3]

Significance Test	Current Rule	As Amended
Investment Test	• 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)	• Measure the registrant's investments in and advances to 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) o Calculate aggregate equity market value using the average for the last five trading days of the registrant's most recently completed month ending prior to the earlier of the registrant's announcement of the transaction or the agreement date o Include contingent consideration required to be recognized at fair value under GAAP, and if not so required, include all contingent consideration except that for which the likelihood of payment is remote • Use the current test if the registrant's market value is not available (such as for an IPO registrant)
Asset Test	• The registrant's proportionate share of the acquired business's assets (as reflected in the business's most recent pre-acquisition annual financial statements) is measured against the registrant's total assets	• Substantially the same, but o For acquisitions, eliminate intercompany transactions with the acquired business from the registrant's total assets

[3] The changes in the tests similarly apply to the definition of "significant subsidiary" under the rules. Note that the above changes to the Investment Test apply only to acquisitions and dispositions.

Significance Test	Current Rule	As Amended
Income Test	• The pre-tax income of the continuing operations of the acquired business is compared to that of the registrant	• Add a revenue component where each of the registrant and the acquired business have had material revenue in each of the two most recently completed fiscal years o Designed to eliminate anomalous results that may arise from relying exclusively on an income test (such as where the registrant has little income) • Require that the registrant exceed both the revenue and net income components (when the revenue component applies), but use the lower result to determine significance level

Under the 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 acquired business historical and pro forma financial information. The amendments expand this use of pro forma information to measure significance to cover post-fiscal year end dispositions as well where the requisite financial information has been filed. However, the "Autonomous Entity Adjustments" and "Management's Adjustments" described below are not permitted to be used in applying these pro forma tests to determine whether an acquisition is significant.

Modifications to Required Historical Financial Statements of the Acquired Business

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

Significance (under *any* of the three tests)	Required Acquired Business Financial Statements	
	Current Rule	**As Amended**
Greater than 20% but less than 40%	• One year of audited financial statements • Interim unaudited financial statements for subsequent interim period, together with corresponding prior year interim period	• Same, but prior comparative period for interim period not required
Greater than 40% but less than 50%	• Two years of audited financial statements • Same as above for interim periods	• No change
Greater than 50%	• Three years of audited financial statements • Same as above for interim periods	• Audited financial statement requirement reduced to two years

The amendments 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 either nine months (where significance exceeds 20% but does not exceed 40%) or a full fiscal year (where significance exceeds 40%), 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 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 the 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 enhance the pro forma presentation of the transaction, the amendments create three categories of adjustments:

- "*Transaction Accounting Adjustments*," which depict (i) the accounting for the transaction required by GAAP or IFRS, as applicable, in the pro forma 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 income statements. The Transaction Accounting Adjustments also require disclosure of:
  - The total consideration paid, including information regarding any contingent consideration; and
  - When the initial accounting is incomplete, a prominent statement to this effect and information relating to the incomplete items, including regarding the magnitude of any potential adjustments.
- "*Autonomous Entity Adjustments*," which 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*," which 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 from closing facilities, discontinuing product lines, terminating employees and modifying contractual agreements.

Under the final rules, Transaction Accounting Adjustments and Autonomous Entity Adjustments are *required* pro forma adjustments, while Management's Adjustments are *optional*. The first two categories of adjustments are presented in separate columns to distinguish between (i) the accounting effects of the underlying acquired business on the registrant and (ii) the standalone operations and financial position of a registrant that was previously part of another entity. The third category, Management's Adjustments, illustrates the operational effects of management's plans (which are subject to their discretion and other uncertainties) and are presented in the explanatory notes (rather than in a third column) in the form of reconciliations of pro forma net income from continuing operations attributable to the controlling interest and the pro forma earnings per share data after giving effect to Management's Adjustments.

In the adopting release, the SEC encourages registrants to provide Management's Adjustments for synergies and dis-synergies if, in management's opinion, such adjustments would enhance an understanding of the pro forma effects of the transaction, provided that certain additional conditions are met. In response to comments received, the final rules require, in providing these Management's Adjustments, that:

- there is a reasonable basis for each such adjustment;
- the adjustments are 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 such synergies and dis-synergies existed as of the beginning of the fiscal year presented (and, if such adjustments reduce expenses, the reduction shall not exceed 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 included (and, if synergies are presented, any related dis-synergies must also be presented).

The explanatory notes must also include disclosure of the basis for and material limitations of each Management's Adjustment, including any material assumptions or uncertainties of such adjustment, an explanation of the method of calculation of the adjustment, if material, and the estimated time frame for achieving the synergies and dis-synergies of such adjustment. Disclosure of revenues, expenses, gains and losses, and related tax effects that will not recur following 12 months after the closing of the transaction is also required.

The SEC declined to create a new safe harbor for this forward-looking information, noting, in an instruction to the amended rules, that it is expressly covered by the existing safe harbor provisions.

Other Changes

The SEC's amendments also include the following:

- permitting registrants, in connection with certain acquisitions of assets that constitute a business, to provide abbreviated financial statements in the form of statements of the assets acquired and liabilities assumed, provided that certain conditions are met, including that the total assets and revenues of the acquired business comprise 20% or less of the corresponding amounts of the seller. In such case, the registrant may provide a statement of revenues and expenses of the acquired business that omits corporate overhead, interest and income tax 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 to provide that historical financial statements are not required, even where such acquisitions exceed 50% significance in the aggregate; instead, in such event,

pro forma financial information reflecting the aggregate effect of the acquired businesses in all material respects is required;

- 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.

In connection with the adoption of the amendments, Chairman Jay Clayton stated: "This action, which is designed to enhance the quality of information that investors receive while eliminating unnecessary costs and burdens, will benefit investors, registrants and the market more generally." Commissioner Allison Herren Lee, in voting against the amendments, expressed concern that the amendments decrease transparency regarding acquisitions (particularly if the financial information provided includes atypical periods impacted by the COVID-19 pandemic) and encourage increasing economic concentration by facilitating acquisitions, without any study of the risks of doing so.

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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