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## SEC Rule amendments ease financial disclosures about business acquisitions and dispositions

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On May 21, 2020, the Securities and Exchange Commission (SEC) issued a release adopting amendments to the rules governing financial disclosures public companies must provide when they buy and sell businesses. The amendments are intended to, among other things, improve the financial disclosures provided to investors about acquired or disposed businesses, and reduce the cost and complexity public companies face in preparing these disclosures.

Specifically, the amendments cover, among other things: (i) the significance tests for acquisitions and dispositions; (ii) Rule 3-05 of Regulation S-X financial statement requirements; (iii) Rule 3-14 of Regulation S-X financial statements of real estate operations acquired or to be acquired; and (iv) pro forma financial information. The amendments are effective as of January 1, 2021. Voluntary adoption is permitted.

### Significance test for acquired businesses and disposed subsidiaries

When a public company (a registrant) acquires a business or disposes of a subsidiary, the amount of financial disclosure that must be provided depends on the relative significance of the acquisition or disposition to the registrant. The significance is measured using the prescribed investment, asset, and income tests set forth in the “significant subsidiary” definition in Rule 1-02(w) of Regulation S-X. Rule 3-05 of Regulation S-X requires the registrant to provide separate audited annual and unaudited interim pre-acquisition financial statements of the business (Rule 3-05 financial statements) if any of the investment, asset, or income tests exceeds the 20% significance threshold. The periods for which Rule 3-05 financial statements are required also depend on the relative significance of the business acquired or to be acquired.

The amendments update the significance tests by revising the investment test and income test, and also make other conforming changes. The amendments do not change the asset test except for a number of non-substantive revisions. The amendments also conform, to the extent applicable, the tests used to determine the significance of a disposed business to those used to determine the significance of an acquisition.

### ***Investment test***

Under the current rules, the investment test is determined by comparing the registrant's and its other subsidiaries' investment in and advances to the acquired business to the total assets of the registrant reflected in its most recent annual financial statements required to be filed at or prior to the acquisition date.

For acquisitions and dispositions, the amended investment test will compare the registrant's and its other subsidiaries' investments in and advances to the acquired business or disposed subsidiary to the aggregate worldwide market value of the registrant's voting and non-voting common equity when available, as opposed to the total consolidated assets of the registrant. The current investment test is retained when the registrant does not have an aggregate worldwide market value or when the test is used for purposes other than acquisitions and dispositions for which the Rule 1-02(w) definition is applicable, such as determining the significance of a wholly owned subsidiary.

The aggregate worldwide market value is to be determined by using the average aggregate worldwide market value calculated daily for the last five trading days of the most recently completed month ending prior to the earlier of the announcement date or agreement date of the acquisition or disposition. In addition, it should be noted that the aggregate worldwide market value is calculated differently from the calculation to determine accelerated filer status because the calculation under Rule 1-02(w) **includes** the value of common equity held by affiliates.

The amendment provides that "investments in" include the fair value of contingent consideration if required to be recognized at fair value by the registrant under U.S. GAAP, however, if recognition at fair value is not required, it must include all contingent consideration, except contingent consideration for which the likelihood of payment is remote.

The amendments provide for an exception to the use of aggregate worldwide market value when evaluating equity method investments under Rules 3-09 and 4-08(g) of Regulation S-X. When evaluating equity method investments, for purposes other than acquisitions, "investments in" should be compared to the registrant's total assets for testing significance.

### ***Income test***

The current income test compares the registrant's equity in the acquired business's or disposed subsidiary's income from continuing operations before income taxes exclusive of amounts attributable to any noncontrolling interests to such income of the registrant, reflected in its most recent annual financial statements required to be filed at or prior to the acquisition date.

The amended income test adds a revenue component that compares a registrant's and its other subsidiaries' proportionate share of the acquired business's or disposed subsidiary's consolidated total revenues from continuing operations (after intercompany eliminations) to the registrant's consolidated total revenues for the most recently completed fiscal year. To satisfy the income test, as amended, the acquired business or disposed subsidiary must meet both the revenue component and the net income component when the revenue component applies, and for purposes of Rule 3-05, may use the lower of the revenue component and the net income component to determine the number of periods for which the Rule 3-05 financial statements are required. The revenue component does not apply if either the registrant or the acquired business or disposed subsidiary did not have material revenue in each of the two most recent fiscal years.

The amended income test also clarifies the existing net income component by using the absolute values of the acquired business's or disposed subsidiary's consolidated income or loss from continuing operations to prevent misinterpretation from including a negative amount in computations. It also adopts the use of absolute values for calculating average net income.

#### ***Use of pro forma financial information to measure significance***

Under current rules, registrants are permitted to base their significance calculations on pro forma financial information reflecting prior acquisitions that the registrant completed since its last audited balance sheet date only if the audited financial statements of the acquired business were filed on Form 8-K. Under the amended rules, a Form 8-K filing is no longer required, and registrants may use pro forma financial information provided it has filed Rule 3-05 financial statements for any such acquired business and pro forma financial information required by Article 11 of Regulation S-X for any such acquired or disposed business. Once a registrant uses pro forma financial information to measure significance, it must continue to use pro forma financial information to measure significance until the next annual report on Form 10-K or Form 20-F.

If the Rule 3-05 financial statements and pro forma financial information are included in an initial registration statement, the registrant can use that pro forma financial information in determining the significance of additional acquisitions subsequent to those acquisitions.

### **Rule 3-05 financial statements**

#### ***Financial statement periods covered***

Currently, a registrant is required to provide Rule 3-05 financial statements for up to three years based on the relative significance of the acquired or to-be-acquired business. The amendments revise Rule 3-05 to reduce the requirement to up to two years of Rule 3-05 financial statements instead of three. In addition, for an acquired business where a significance test exceeds 20%, but does not exceed 40%, the amended Rule 3-05 will only require the "most recent" interim period, eliminating the need to provide a comparative interim period when only one year of audited Rule 3-05 financial statement is required.

It is noteworthy that the amendments do not substantively modify the financial statement requirements of Rule 3-05(b)(1) applicable to where securities are being registered (on Form S-4) to be offered to the shareholders of the business to be acquired.

#### ***Omission of Rule 3-05 financial statements***

Currently, Rule 3-05 financial statements may be omitted once the operating results of the acquired business have been reflected in the audited consolidated financial statements of the registrant for a complete fiscal year. However, Rule 3-05 financial statements are required to be included in registration statements when they have not been previously filed or when the 3-05 financial statements have been previously filed, but the acquired business is of "major significance" to the registrant. An acquired business is deemed to be of "major significance" if the omission of the Rule 3-05 financial statements would materially impair an investor's ability to understand the historical financial results of the registrant. Rule 3-05 provides, as an example of "major significance," an acquired business that exceeds at the 80% level the significance threshold of any of the significance tests.

The amendments eliminate the requirement to include Rule 3-05 financial statements in registration statements and proxy statements once the acquired business is reflected in filed post-acquisition registrant financial statements, regardless of whether they were previously separately filed, for a certain requisite time period, depending on the significance level of the acquired business. The amendments allow omission of pre-acquisition financial statements for businesses that exceed 20%, but do not exceed 40%, significance once they are included in the registrant's audited post-acquisition results for nine months, and allow omission for businesses that exceed 40% significance once they are included in the registrant's post-acquisition results for a complete fiscal year. In addition, the amendments removed the "major significance" exception.

When a registrant acquires a component of an entity that is a business as defined in Rule 11-01(d) but does not have separate financial statements or maintain separate accounts to prepare Rule 3-05 financial statements, the amendments will permit the registrant to provide abbreviated financial statements coupled with additional required disclosures if the following conditions are met:

- The total assets and total revenues (both after intercompany eliminations) of the acquired or to be acquired business constitute 20% or less 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 periods for which the acquired business financial statements would be required
- Separate financial statements for the business have not previously been prepared
- The seller has not maintained the distinct and separate accounts necessary to present financial statements that include the omitted expenses, and it is impracticable to prepare such financial statements.

#### ***Individually insignificant acquisitions***

The amendments to Rule 3-05 also reduce the burdens of preparing disclosure about immaterial acquisitions. Under current rules, Rule 3-05 financial statements are generally not required if an acquired or to-be-acquired business (i) does not exceed 20% significance, or (ii) does not exceed 50% significance and the acquisition has not yet occurred or the date of the final prospectus or prospectus supplement relating to an offering is no more than 74 days after consummation and the financial statements have not been previously filed. If the aggregate impact of individually insignificant businesses acquired since the date of the most recent audited balance sheet filed for the registrant exceeds 50%, audited historical pre-acquisition financial statements covering at least the substantial majority of the businesses acquired must be included in a registration statement or proxy statement.

The amendments continue to require Rule 3-05 financial statements if the aggregate impact of independently insignificant businesses exceeds 50%. In this regard, individually insignificant businesses include:

- Any acquisition consummated after the registrant's audited balance sheet date, the significance of which does not exceed 20%
- Any probable acquisition, the significance of which does not exceed 50%

- Any consummated acquisition, the significance of which exceeds 20%, but does not exceed 50%, for which financial statements are not yet required because of the 75-day filing period

The amendments will only require pre-acquisition historical financial statements for businesses whose individual significance exceeds 20%. However, the amended rules will require registrants to provide pro forma financial information depicting the aggregate effects of all individually insignificant businesses since the date of the most recent audited balance sheet filed for the registrant. Consequently, registrants should negotiate for the timely provision of historical balance sheet and income statement information for each acquisition.

### ***Other amendments***

The amendments codify reporting practices with respect to acquisitions of a significant business that includes oil and gas producing activities. Under the amended rules, a registrant that acquires a business with significant oil- and gas-producing activities will be required to include certain ASC 932 disclosures in Rule 3-05 financial statements of the acquired business. Additionally, if certain conditions are met, Rule 3-05 financial statements may consist of only audited statements of revenues and expenses that exclude depreciation, depletion, and amortization expense, corporate overhead expense, income taxes, and interest expense that are not comparable to the proposed future operations.

Additionally, the amendments also (i) specify and clarify certain timing and terminology for requirements of Rule 3-05 financial statements, (ii) permit a foreign registrant or a registrant acquiring a foreign business to present Rule 3-05 financial statements prepared in accordance with IFRS-IASB if certain conditions are met, and (iii) revise Rule 8-04 to reference to Rule 3-05 for smaller reporting company requirements relating to the financial statements of businesses acquired or to be acquired, other than for form and content requirements for such financial statements.

### **Rule 3-14 financial statements of real estate operations**

Rule 3-14 provides differentiated disclosure requirements for real estate operations. Rule 3-14 was amended to align with Rule 3-05 to standardize the disclosure requirements for acquired businesses while retaining necessary industry-specific disclosures.

Specifically, the Rule 3-14 amendments align the significance threshold for individual acquisitions to 20% and aggregate the impact of acquisitions to 50%, same as in Rule 3-05. The amendments also eliminate the specific requirement to provide three years of financial statements for acquisitions from related parties. Rule 3-06, which permits financial statements covering a period of nine to twelve months to satisfy the requirement for filing financial statements for a period of one year, was expanded to include Rule 3-14 financial statements. Under the amendments, the Rule 3-14 financial statements will include the same period for the filing in registration statements and proxy statements as under Rule 3-05, and they will not be required in the registration statements and proxy statements once the acquired real estate operations are reflected in filed post-acquisition registrant financial statements for nine months. The amendments also include other conforming changes.

The Rule 3-14 amendment includes a definition of a real estate operation as “a business that generates substantially all of its revenues through the leasing of real property.”

With respect to significance tests, the amended Rule 3-14 will require the use of the investment test in the amended Rule 1-02(w) and, therefore, use aggregate worldwide market value. If the aggregate worldwide market value is unavailable, the investment test would be based on total assets. When based on total assets, the investment test will compare the registrant's investment amount in the real estate operation, including any debt secured by the real properties assumed by the registrant, to the registrant's total assets as of the end of the most recent fiscal year.

The amendments also specifically require Rule 3-14 financial statements for the most recent year-to-date interim period prior to the acquisition to be consistent with current practice and pro forma requirements under Article 11.

With respect to smaller reporting companies and issuers relying on Regulation A, Article 8 is amended to simplify and conform the application of amended Rule 3-14.

The amendments codify certain staff interpretations in connection with registrants conducting blind pool real estate offerings, which are typically non-traded real estate investment trusts. In this regard, the staff has adapted significance tests when determining whether these registrants are required to provide Rule 3-14 financial statements. Consequently, the amendments provide that the significance for blind pool offerings must be computed by comparing the registrant's investments in the real estate operation to the sum of the registrant's total assets as of the date of the acquisition and the proceeds (net of commissions) in good faith expected to be raised in the registered offering over the next 12 months. This adapted significance test will also apply to Rule 3-05 acquisitions by registrants in blind pool offerings.

## **Pro forma financial information**

### ***Adjustment criteria and presentation requirements***

Under current rules, registrants are required to file pro forma financial information pursuant to Article 11 of Regulation S-X when the registrant engages in a significant business combination or disposition of a significant portion of a business or any such transaction is probable. The significance is measured using the investment, asset, and income tests from Rule 1-02(w). If any of the significance tests are met, the registrant must file pro forma financial information for the acquired or disposed business.

The amended Article 11 simplifies requirements for pro forma adjustment criteria to depict the accounting for the transaction and the option to present the reasonably estimable synergies and other transaction effects that have occurred or are reasonably expected to occur. Other changes are also made to simplify and clarify Article 11 for more consistent use of terminology.

The revised pro forma adjustment criteria are broken out into three categories: (i) Transaction Accounting Adjustments, (ii) Autonomous Entity Adjustments, and (iii) Management's Adjustments. In the final amendments, Transaction Accounting Adjustments and Autonomous Entity Adjustments are required adjustments while Management's Adjustments are optional.

Transaction Accounting Adjustments reflect only the application of required accounting to the acquisition, disposition, or other transaction linking the effects of the acquired business to the registrant's audited historical financial statements. Autonomous Entity Adjustments 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. Transaction Accounting Adjustments and Autonomous Entity Adjustments are required when their conditions are met and must be reported in separate columns. Historical and pro forma per share data are required to give effect to both Transaction Accounting Adjustments and Autonomous Entity Adjustments.

Management's Adjustments provide both flexibility to registrants—to include forward-looking information that depicts the synergies and dis-synergies identified by management in determining to consummate or integrate the transaction for which pro forma effect is being given—and insight to investors into the potential effects of the acquisition and the post-acquisition plans expected to be taken by management. Under the final amendments, Management's Adjustments showing synergies and dis-synergies of the acquisitions and dispositions may be presented if, in management's opinion, such adjustments would enhance an understanding of the pro forma effects of the transaction. In addition, the registrant must meet the following conditions to present Management Adjustments:

- There is a reasonable basis for such adjustments
- 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 the synergies and dis-synergies existed as of the beginning of the fiscal year presented
- The pro forma financial information reflects all Management 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 disclosed. When synergies are presented, any related dis-synergies must also be presented.

In order to present Management's Adjustments, certain conditions related to the form of presentation must be met. In addition, the Management's Adjustments must be presented in the explanatory notes of the pro forma financial information in the form of reconciliations.

The amendments include an instruction indicating that any forward-looking information supplied is expressly covered by the safe harbour provisions under Rule 175 under the Securities Act of 1933 and Rule 3b-6 under the Securities Exchange Act of 1934.

Additional amendments that further clarify the pro forma financial information disclosure are also adopted to require disclosure of revenues, expenses, gains and losses, and related tax effects that will not recur in the registrant's income beyond 12 months after the transaction.

#### ***Significance test for disposed business***

Currently, Rule 11-01 requires pro forma information for disposition or probable disposition of a significant portion of a business if the disposition is not fully reflected in the financial statements of the registrant. Rule 1-02(w) provides the significance test for disposed business with a 10% significance threshold. Form 8-K also uses a 10% significance threshold for dispositions of assets that do not constitute a business. The amended Rule 11-01 raises the significance threshold from 10% to 20%. This also applies to dispositions of real estate operations under Rule 3-14.

#### ***Smaller reporting companies and issuers relying on Regulation A***

The amendments revise the rules applicable to smaller reporting companies and issuers relying on Regulation A to require that the preparation, presentation, and disclosure of pro forma financial information by smaller reporting companies and issuers substantially comply with Article 11. Under these amendments, in addition to the current requirements applicable to acquisitions, smaller reporting companies and issuers relying on Regulation A will be required to provide pro forma financial information for significant dispositions.

These amendments are effective as of January 1, 2021.

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