

SEC Revises Financial Statement Disclosure Rules For Acquired and Disposed Businesses

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Securities and Capital Markets

On May 20, 2020, the SEC adopted [amendments](#) to requirements for financial disclosures about acquired and disposed businesses. These rules have remained largely static for several decades, even as many other SEC rules and forms have undergone significant revisions in that time period. The amendments are intended to reduce the complexity and costs associated with the determination of whether and when financial information regarding an acquired or disposed business is required and with the preparation of historical financial statements and pro forma financial information. The amendments are effective as of January 1, 2021; however, voluntary compliance is permitted in advance of the mandatory compliance date provided that the amendments are applied in their entirety.

Rule 3-05 of Regulation S-X generally requires a registrant to provide audited annual and unaudited interim historical financial statements of an acquired business (or where such acquisition is probable) if such business surpasses a threshold level of significance. The number of years of financial statements that must be provided depends on the relative significance of the acquisition to the registrant, which is based on the three-part “significant subsidiary” definition in Rule 1-02(w) of Regulation S-X. In addition, Article 11 of Regulation S-X requires registrants to file unaudited pro forma financial information relating to significant acquisitions or dispositions. These filing obligations apply to registration statements (including securities offerings off of effective shelf registration statements) and proxy statements where significant acquisitions or dispositions have been consummated or are probable. In addition, Form 8-K requires a registrant to file required historical financial statements and related pro forma financial information within 71 days of the initial due date to report the consummation of a material acquisition (pro forma financial information giving effect to a material disposition is required with the Form 8-K that reports the disposition).

The amendments revise the tests for determining whether an acquired or disposed business is deemed “significant,” which in turn determines whether certain historical financial statements and pro forma financial information regarding the business must be presented. This alert focuses on a number of key aspects of the amendments, but does not address the amendments relating to financial disclosures applicable to real estate operations and investment companies.

Significance Tests for Acquired and Disposed Businesses

Measuring the significance of a business under Rule 1-02(w) of Regulation S-X involves three tests — the investment, asset and income tests. The most significant changes in the amendments are to the investment and income tests, which are discussed below.¹

Investment Test

- Current Rule: Investments-to-Assets
 - The investment test compares the registrant's investments in the acquired or disposed business to the total assets of the registrant as reflected in its most recent annual financial statements.
 - For this purpose, "investments" in the business generally means the consideration transferred or received (i.e., the purchase or sales price) for the net assets acquired or sold.
- Revised Rule: A New Investments-to-Aggregate Worldwide Market Value Comparison
 - The revised investment test will allow a registrant to compare its investments in the acquired or disposed business to the aggregate worldwide market value of the registrant's voting and non-voting common equity. If the registrant does not have an aggregate worldwide market value (i.e., does not have publicly traded common stock), only the existing investments-to-assets comparison will be used.
 - Aggregate worldwide market value is calculated based on the daily average of the last five trading days of the most recently completed month prior to the earlier of the date the transaction is announced or the date of the transaction agreement.

Income Test

- Current Rule: Income-to-Income
 - The income test compares the registrant's equity in the income from continuing operations of the acquired or disposed business to the same income measure of the registrant as reflected in its most recent annual financial statements.
- Revised Rule: Income and Revenue Comparisons
 - The revised income test contains two components: the existing income comparison and a new revenue comparison. When determining whether an acquisition or disposition is significant using the income test, both of the comparisons must be individually significant in order for the income test threshold to be achieved.
 - The new revenue component compares the consolidated total revenue from continuing operations (after intercompany eliminations) of the acquired or disposed business to the same measure of the registrant for the most recently completed fiscal year.

¹ The revised asset test compares the consolidated total assets (after intercompany eliminations) of the acquired or disposed business to those of the registrant as of the most recent fiscal year end and remains substantively unchanged.

- The revenue component of the income test will not be applicable if either the registrant or the acquired or disposed business did not have material revenue in each of the two most recently completed fiscal years. If the revenue component is not applicable, the income test will effectively consist only of the existing income component.
- If both the income and revenue comparisons are significant (thus satisfying the income test as a whole), the number of years of audited financial statements required, as discussed below, will be determined based on the *lesser* of the revenue component percentage and the income component percentage.

2 Number of Years of Required Financial Statements Based on Significance

Under Rule 3-05 of Regulation S-X, the number of years for which a registrant must provide financial statements of an acquired business is determined based on the level of significance of such business as determined using the three tests noted above. If none of the significance tests exceeds 20%, the financial statements of the acquired business are not required to be filed. Furthermore, in situations where the financial statements of the acquired business are not required to be filed, Rule 11-01(c) of Regulation S-X provides that the acquirer need not present the pro forma effects of the acquisition on its financial statements.

- Current Rule: Three-Year Maximum; Interim Period Comparisons Required
 - Under the current rule, acquisitions that meet any one of the three significance tests require the filing of one to three years of audited financial statements for the acquired business as follows:
 - exceeds 20%, but not 40%, financial statements for the most recent fiscal year;
 - exceeds 40%, but not 50%, a second year is required; and
 - exceeds 50%, a third year is generally required.
 - In each case where audited financial statements are required, unaudited financial statements for the most recent interim period and the corresponding prior year period are also required.
- Revised Rule: Two-Year Maximum; No Interim Period Comparison for Transactions Below 40% Significance
 - Transactions exceeding the 40% significance threshold for any one of the three significance tests will require the registrant to provide two years of audited financial statements, along with unaudited statements for the most recent interim period and corresponding prior year period.
 - Transactions exceeding the 20%, but not 40%, significance threshold, for any one of the three significance tests will require the registrant to provide audited financial statements for the most recent fiscal year, along with unaudited financial statements for the most recent interim period (but not for the prior year period).

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Pro Forma Financial Information

Under Article 11 of Regulation S-X, a registrant is required to provide pro forma financial information reflecting the impact of a significant acquisition or disposition on its financial statements. Typically this includes the most recent balance sheet and annual and interim period income statements.

- **Current Rule:** Adjustments to the pro forma income statement and pro forma balance sheet are limited to those that give effect to events that are directly attributable to the transaction, are factually supportable, and, in the case of the pro forma income statement, are expected to have a continuing impact on the registrant.
- **Revised Rule:** The amendments replace the existing pro forma adjustment criteria with three new categories: (1) transaction accounting adjustments; (2) autonomous entity adjustments; and (3) management's adjustments. Transaction accounting adjustments and autonomous entity adjustments are required and must be presented as separate columns in the pro forma financial statements. Management's adjustments, on the other hand, are optional and are to be presented in the explanatory notes to the pro forma financial information, if certain requirements are met.
 - Transaction accounting adjustments reflect the application of required accounting to the transaction and link the effects of the acquired or disposed business to the registrant's audited historical financial statements.
 - Autonomous entity adjustments are adjustments required in certain situations to reflect the operations and financial position of the registrant as an autonomous entity if the registrant had been previously part of another entity (such as when the registrant itself was previously a subsidiary).
 - Management's adjustments are intended to provide forward-looking information that depicts the synergies and dis-synergies identified by the board and management and provides insight as to the potential effects of the acquisition or disposition and management's post-transaction plans. If a registrant chooses to provide management's adjustments, the revised rule lays out the following mandatory criteria for the basis and form of presentation.
 - There must be a reasonable basis for each adjustment.
 - The adjustments must be limited to the effect of synergies and dis-synergies as if they existed as of the beginning of the fiscal year presented.
 - If synergies are presented, any related dis-synergies must also be presented.
 - Management's adjustments should be presented as reconciliations to pro forma net income from continuing operations and pro forma earnings per share data in the explanatory notes and must include the basis for and material limitations of each adjustment (e.g., any material assumptions or uncertainties, an explanation of the method of calculation, and the estimated time frame for achieving the synergies and dis-synergies).

Acquired Business Financials in Registration and Proxy Statements

The amendments include revisions to Rule 3-05 of Regulation S-X with respect to the inclusion of separate financial statements in registration and proxy statements for acquired businesses.

- Omission of Separate Financials After Inclusion in Registrant's Audited Financials
 - Current Rule: Separate financial statements for an acquired business generally may be omitted from a registration and proxy statement once the operating results of the acquired business have been reflected in the registrant's post-acquisition audited consolidated financial statements for a complete fiscal year.
 - Separate financial statements are still required, however, even after the one-year period if (i) the acquired business is of major significance (e.g., 80% or greater) to the registrant and the omission of separate financial statements would materially impair an investor's ability to understand the historical financial results of the registrant, or (ii) when the financial statements of the acquired business have not been previously filed. The effect of the latter requirement can be to require an IPO registrant to provide separate acquiree financial statements for reporting periods that are older than would be required if the IPO registrant was already a public company.
 - Revised Rule: The amendments allow for the omission of separate financial statements for acquired businesses that exceed 20% but do not exceed 40% significance once those financial statements have been reflected in the registrant's audited post-acquisition financial statements for nine months.² For acquired businesses that exceed 40% significance, there is no change from the current rule -- separate financial statements may be omitted once they are reflected in the registrant's audited post-acquisition financial statements for a complete fiscal year.
 - The amendments eliminate the requirement to include separate financial statements following this period when the acquired business is of major significance to the registrant or if the separate financials were not previously filed.
- Measuring Significance in Registration and Proxy Statements Using Pro Forma Financial Information
 - Current Rule: Significance determinations are generally required to be made by comparing the most recent annual financial statements of an acquired business to those of the registrant prior to the date of the acquisition. However, a registrant is generally permitted to use pro forma, rather than historical, financial information to test significance of a subsequently acquired business if the registrant made a significant acquisition after the last fiscal year end and filed separate historical financial statements under Rule 3-05 and pro forma financial information on Form 8-K.

² As noted in the adopting release for the amendments, existing SEC staff practice as documented in Section 2040.2 in the Division of Corporation Finance's Financial Reporting Manual generally permits omission of previously filed acquired business financial information once it is included in the registrant's post-acquisition results for nine months.

- **Revised Rule:** The amended rule removes the Form 8-K filing requirement and allows registrants to use pro forma, rather than historical, financial information when testing the significance of a subsequently acquired business for purposes of financial statements included in initial registration statements. A pending IPO registrant can now use filed pro forma financial information when testing significance of a subsequently acquired business (i.e., to determine whether separate financial statements and pro forma financial information *of the subsequently acquired business* would be required in the initial registration statement). Once a registrant uses pro forma financial information to measure significance, it must continue to use pro forma financial statements for further measurements of significance until it files its next annual report on Form 10-K or Form 20-F.
- Rationalized Presentation of Individually Insignificant Acquisitions
 - **Current Rule:** If the aggregate impact of “individually insignificant businesses” acquired since the date of the most recent audited balance sheet exceeds 50% significance, audited historical pre-acquisition financial statements and pro forma financial information covering at least the substantial majority of the businesses acquired must be included in a registration statement or proxy statement.
 - **Revised Rule:** The amendments require registrants to provide pre-acquisition historical financial statements only for those businesses that are individually significant at a level in excess of 20%. Registrants will still be required to provide pro forma financial information, but only pro forma financial information depicting the aggregate effects of all “individually insignificant businesses” (instead of a subset, as has previously been the practical effect of the rules).

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Other Notable Provisions

- Abbreviated Financial Statements
 - When a registrant acquires a component of an entity, such as a product line or a line of business that is considered a “business” under Rule 11-01(d) of Regulation S-X but does not constitute a separate entity, subsidiary or division, separate financial statements of the acquired business may not be available. In these circumstances, registrants frequently seek relief from the SEC staff to provide abbreviated financial statements of the acquired business. Under the amendments, this will no longer be necessary if the conditions of new Rule 3-05(e) of Regulation S-X are met. This new rule will permit registrants to provide abbreviated financial statements, in the form of statements of assets acquired and liabilities assumed and statements of revenues and expenses, as long as the acquired business constitutes 20% or less of the assets or revenue of the seller.
 - The amendments codify existing staff accommodations that allow for the presentation of abbreviated financial statements for certain acquired businesses where it is impracticable for a registrant to prepare full financial statements (such as where the acquired business was not a separate entity or was a segment of the seller and for which the seller did not maintain separate financial accounts or statements).

- In situations where an acquired business exceeds the 20% threshold, but the registrant nonetheless confronts unique challenges in presenting separate financial statements, the option of requesting relief from the SEC staff would still be available.
- Significance Test for Business Dispositions
 - The amendments raise the significance threshold for the disposition of a business from 10% to 20% and conform the tests used to determine the significance of a disposed business to those used to determine the significance of an acquired business.
- Smaller Reporting Companies
 - The amendments make corresponding changes to the smaller reporting company requirements in Article 8 of Regulation S-X.

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