
May 13, 2019

SEC Proposes to Streamline Disclosures Relating to Acquisitions and Dispositions

On May 3, the SEC proposed rule changes (available [here](#)) to streamline the information that investors receive in connection with significant acquisitions of other businesses. The proposed amendments are intended to facilitate more timely access to capital and reduce complexity and compliance costs of the financial disclosures triggered by significant acquisitions.

The proposed rule changes are the result of the SEC's ongoing evaluation of disclosure requirements, including its 2015 Request for Comment on the Effectiveness of Financial Disclosures About Entities Other Than the Registrant (available [here](#)).

If adopted, the proposed rules would amend portions of Rule 3-05, 3-14 and Article 11 of Regulation S-X, make corresponding changes to the smaller reporting company requirements in Article 8 of Regulation S-X and introduce new Rule 6-11 of Regulation S-X.

Background

When registrants acquire a significant business, other than a real estate operation, Rule 3-05 of Regulation S-X (*Financial statements of businesses acquired or to be acquired*) generally requires these registrants to provide separate audited annual and unaudited interim pre-acquisition financial statements of that business. The number of years of financial information that must be provided depends on the relative significance of the acquisition to the registrant. Similarly, Rule 3-14 of Regulation S-X (*Special instructions for real estate operations to be acquired*) addresses real estate operations and requires registrants that have acquired a significant real estate operation to file financial statements with respect to such acquired operation.

Article 11 of Regulation S-X requires registrants to file unaudited pro forma financial information relating to the acquisition or disposition. Pro forma financial information typically includes a pro forma balance sheet and pro forma income statements based on the historical financial statements of the registrant and the acquired or disposed business, including adjustments intended to show how the acquisition or disposition might have affected the registrant's financial statements.

Proposed Amendments

The proposed changes would, among other things:

- **Update the significance tests when evaluating what financial statements are required.** Whether an acquisition is significant under Rule 3-05 is determined by applying the investment, asset and income tests in the “significant subsidiary” definition. The SEC proposes to revise the investment and income tests in part to reduce the anomalous results that can occur in the application of the definition of “significant subsidiary.”

The investment test compares the company’s investment in the acquired business to the carrying value of the company’s total assets. The SEC proposes to revise the investment test to compare the company’s investment in the acquired business to the aggregate worldwide market value of the company’s voting and non-voting common equity, when available. If there is no aggregate worldwide market value, a registrant would use the existing test.

The income test compares the company’s equity in the income from continuing operation of acquired business, before income taxes, exclusive of amount attributable to any non-controlling interests, as reflected in the business’s most recent annual pre-acquisition financial statements to the same measure of the company as reflected in its most recent annual financial statements required to be filed at or prior to the acquisition. The SEC proposes to revise the income test by adding a new revenue component and simplifying the calculation of the net income component by using income or loss from continuing operations *after* income taxes.

The new income test would require that the tested subsidiary meet *both* the new revenue component and the net income component where the registrant and its consolidated subsidiaries and the tested subsidiary have recurring annual revenue. The registrant would use the lower of the revenue component and the net income component to determine the number of periods for which Rule 3-05 financial statements are required. Where the registrant or the tested subsidiary does not have recurring annual revenues, only the net income component would apply with the registrant asked to use the average of the absolute value of net income when the existing 10% threshold in computational Note 2 to Rule 1-02(w) is met and the proposed revenue component does not apply.

- **Limit the financial statement requirement to a maximum of two years.** In the proposing release, the SEC notes that two years of pre-acquisition financial statements would be sufficient to allow investors to understand the possible effects of an acquired business on the registrant. Accordingly, the SEC proposes eliminating the requirement to file the third year of Rule 3-05 financial statements for an acquisition that exceeds 50% significance.

The SEC also proposes revising Rule 3-05 for acquisitions where a significance test exceeds 20%, but none exceeds 40%, to require financial statements for the “most recent” interim period specified in Rule 3-01 and 3-02 rather than “any” interim period. This would allow registrants to avoid including a comparative interim period when only one year of Rule 3-05 audited financial statements are required.

- ***Permit abbreviated financial statements in certain circumstances.*** The SEC notes that registrants frequently acquire a component of an entity, such as a product line or a line of business, that does not itself constitute a separate entity and may not have separate financial statements necessary to prepare Rule 3-05 financial statements because the component often represents only a small part of the selling entity. In these circumstances, making appropriate allocations of the selling entity’s overhead and other expenses may be impractical. The SEC proposes to permit registrants to provide abbreviated financial statements regarding assets acquired and liabilities assumed if certain conditions are met.¹
- ***Clarify when financial statements and pro forma information are required.*** The proposed amendments would specify that financial statements are required if a business acquisition has occurred during the most recent fiscal year or subsequent interim period for which a balance sheet is required by Rule 3-01 of Regulation S-X or if a business acquisition has occurred or is probable after the date that the most recent balance sheet has been filed. The SEC also proposes replacing the term “furnish” with “file” to make clear that the information required by Rule 3-05 and Article 11 must be filed with the SEC. Finally, references to “business combinations” would be replaced with references to “business acquisitions” to make clear that Rule 3-05 and Article 11 are not limited to “business combinations” as the term is used under U.S. GAAP.

The proposed amendments also would provide that a registrant may continue to determine significance using amounts reported in its Form 10-K for the most recent fiscal year when the registrant has filed its Form 10-K after the acquisition consummation date, but before the date the registrant is required to file financial statements of the acquired business on Form 8-K. The SEC proposes to permit rather than

¹ The conditions to be met would include: (i) the business constitutes less than substantially all of the assets and liabilities of the seller and was not a separate entity, subsidiary, segment or division during the periods for which the acquired business financial statements would be required; (ii) separate financial statements for the business have not previously been prepared; (iii) 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; (iv) interest expense may only be excluded from the statements if the debt to which the interest expense relates will not be assumed by the registrant or its consolidated subsidiaries; (v) the statements of revenues and expenses do not omit selling, distribution, marketing, general and administrative, and research and development expenses incurred by or on behalf of the acquired business during the periods to be presented; and (vi) the notes to the financial statements include certain additional disclosures.

require use of the more recent Form 10-K in this circumstance to avoid creating an incentive for registrants to delay the filing of their Form 10-K reports.

- **Permit the use of International Financial Reporting Standards.** The SEC is proposing limited modifications to Rule 3-05 to permit acquired business financial statements to be prepared in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board (“IFRS-IASB”) without reconciliation to U.S. GAAP if the acquired business would qualify to use IFRS-IASB if it were a registrant.

This modification aims to remedy a circumstance where, due to the divergent ownership criteria in the definition of “foreign private issuer” and “foreign business,” an acquired business that does not meet the definition of foreign business, but would otherwise be permitted to present its financial statements using IFRS-IASB as a foreign private issuer, is not permitted to use financial statements prepared in accordance with IFRS-IASB for its Rule 3-05 financial statements even when those financial statements are already available and instead must prepare the Rule 3-05 financial statements in accordance with U.S. GAAP. This modification would treat financial statements prepared in accordance with IFRS-IASB as sufficient for investors as long as the acquired business has a sufficient foreign nexus to meet the definition of foreign private issuer.

A second modification would permit foreign private issuers that prepare their financial statements using IFRS-IASB to provide acquired business financial statements prepared using home country GAAP to be reconciled to IFRS-IASB, rather than to U.S. GAAP.

- **No longer require separate acquired business financial statements after one year.** The SEC proposes to no longer require acquired business financial statements once the acquired business is reflected in filed post-acquisition registrant financial statements for a complete fiscal year. This change would eliminate the requirement that acquired business financial statements continue to be provided when they have not been previously filed or when they have been previously filed but the acquired business is of major significance (*e.g.*, at the 80% level).
- **Expanded use of pro forma financial information for significance testing.** A registrant is permitted to use pro forma, rather than historical, financial information to make significance determinations if the registrant made a significant acquisition subsequent to the latest fiscal year-end and filed its Rule 3-05 financial statements and pro forma financial information on Form 8-K. The SEC proposes to allow companies to measure significance using filed pro forma financial information that only depicts significant business acquisitions and dispositions consummated after the latest fiscal year-end for which the registrant’s financial statements are required to be filed, subject to the following conditions: (i) the registrant has filed Rule 3-05 or Rule 3-14 financial statements for any such acquired business and (ii) the registrant has filed the pro forma financial information required by Article 11 for

any such acquired or disposed business. When determining significance using pro forma financial information, registrants would be unable to use Management's Adjustments (see below).

- ***Modifications to the required disclosure for the aggregate effect of acquisitions for which financial statements are not required or are not yet required.*** Audited historical pre-acquisition financial statements generally are 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 as filed with the SEC is no more than 74 days after consummation and the financial statements have not been previously filed. However, 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.

Under proposed Rule 3-05(b)(2)(iv), disclosure would be required only if the aggregate impact of businesses acquired or to be acquired since the date of the most recent audited balance sheet filed for the registrant, for which financial statements are either not required by paragraph (b)(2)(i) or are not yet required based on paragraph (b)(4)(i), exceeds 50%. The proposed rule, however, would require registrants to provide pro forma financial information depicting the aggregate effects of all such businesses in all material respects and pre-acquisition historical financial statements only for those businesses whose individual significance exceeds 20%, but are not yet required to file financial statements.

- ***Amend pro forma financial information requirements to improve its relevance.*** Article 11 of Regulation S-X governs the disclosure requirements for pro forma financial statements (typically consisting of the most recent balance sheet and most recent annual and interim period income statements) that must accompany Rule 3-05 and Rule 3-14 financial statements. Pro forma financial information for a business acquisition consists of historical financial statements of the registrant and the acquired business and is adjusted for certain items if specified criteria are met (*i.e.*, adjustments in the case of income statement information that are directly attributable to the transaction, are expected to have a continuing impact on the registrant and are factually supportable, and in the case of balance sheet information that are directly attributable and factually supportable).

The proposed rules amend the pro forma financial information requirements to improve the content and relevance of such information. Under the proposals, Article 11 would be revised by replacing the existing pro forma adjustment criteria with simplified requirements to depict the accounting for the transaction and present the reasonably estimable synergies and other transaction effects that have occurred or are reasonably expected to occur. The proposed adjustments would be broken out into two categories:

- “*Transaction Accounting Adjustments*” that would depict: (1) in the pro forma condensed balance sheet, the accounting for the transaction required by U.S. GAAP or IFRS-IASB, and (2) in the pro forma condensed income statements, the effects of those pro forma balance sheet adjustments assuming the adjustments were made as of the beginning of the fiscal year presented; and
- “*Management’s Adjustments*” that would be required for and limited to synergies and other effects of the transaction, such as closing facilities, discontinuing product lines, terminating employees, and executing new or modifying existing agreements, that are both reasonably estimable and have occurred or are reasonably expected to occur. Specified presentation requirements for this category would also be included to permit investors to distinguish the accounting effects on the registrant of the underlying acquired business from operational effects of management’s plans that are subject to management’s discretion or other uncertainties
- **Revise significance threshold for the disposition of a business.** The proposed rules also revise Rule 11-01(b) to raise the significance threshold for the disposition of a business from 10% to 20% to conform it to the threshold at which an acquired business is significant under Rule 3-05; and to conform, to the extent applicable, the tests used to determine significance of a disposed business to those used to determine the significance of acquired business.
- **Align Rule 3-14 with Rule 3-05 where no unique industry considerations exist and clarify the application of Rule 3-14 regarding the determination of significance.** In the proposing release, the SEC notes that aligning Rule 3-14 with Rule 3-05 will reduce complexity by standardizing the requirements for acquired businesses overall while retaining the industry specific disclosure. It further notes that when determining whether an acquisition is “significant,” the use of the asset or income tests generally is not practical for a real estate operation, because the historical amounts of assets and income of the acquired or to be acquired real estate operation are not available. Accordingly, the SEC proposes to amend Rule 3-14 to specify the use of a modified investment test.

Other amendments aimed at aligning Rule 3-14 with Rule 3-05 include: (i) eliminating the Rule 3-14 requirement to provide three years of financial statements for acquisitions from related parties; (ii) revising Rule 3-06 to permit the filing of financial statements covering a period of nine to 12 months to satisfy the requirement for filing financial statements for a period of one year for an acquired or to be acquired real estate operation; (iii) amending Rule 3-14 to include the same period for the filing of Rule 3-14 financial statements in registration statements and proxy statements as exists under Rule 3-05; and (iv) no longer requiring Rule 3-14 financial statements in registration statements and proxy statements once the acquired real estate operation is reflected in filed post-acquisition registrant financial statements for a complete fiscal year.

- **Simplify the smaller reporting company requirements in Regulation S-X.** In order to simplify the application of the rules regarding smaller reporting company disclosure requirements for

the financial statements of businesses acquired or to be acquired, the SEC proposes to revise those rules to direct smaller reporting companies to Rule 3-05 for certain of these requirements.

The proposal will be subject to a 60-day public comment period following its publication in the Federal Register.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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