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May 27, 2020

## **SEC Adopts Amendments to Streamline Disclosures Relating to Acquisitions and Dispositions**

On May 20, 2020, the SEC adopted final rules (available [here](#)) amending Regulation S-X to streamline the information that SEC registrants must disclose in connection with significant acquisitions of other businesses as well as dispositions. The final rules, which become effective on January 1, 2021, amend portions of Rule 3-05, Rule 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 that covers financial reporting in the event of a fund acquisition by an investment company. As such, the amendments affect both the financial statements that must be presented for significant acquired/to be acquired businesses as well as pro forma financial information reflecting such acquisitions, or significant dispositions.

### **Background**

When a registrant acquires a significant business, other than a real estate operation, Rule 3-05 generally requires it to provide separate audited annual and unaudited interim pre-acquisition financial statements for that business. The number of years covered by these financial statements varies depending upon the relative significance of the acquired business to the registrant. Similarly, Rule 3-14 addresses real estate operations and requires a registrant that has acquired a significant real estate operation to provide financial statements with respect to such acquired operation.

Article 11 requires a registrant to provide unaudited pro forma financial information relating to a significant 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.

### **Final Amendments**

The final rule changes will, among other things:

**Update the significance tests.** Whether an acquisition is significant under Rule 3-05 is determined by applying the investment, asset and income tests found in the "significant subsidiary" definition. The final rules revise the investment and income tests, in part to reduce the anomalous results that can occur in the

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application of the tests. While the SEC decided not to revise the asset test, the final rules clarify that for acquisitions, intercompany transactions with the acquired business must be eliminated from the registrant's and its subsidiaries' consolidated total assets when computing the test.

- **The investment test.** The investment test currently compares the registrant's and its other subsidiaries' investments in and advances to the tested subsidiary to the total assets of the registrant and its consolidated subsidiaries. The final rules revise the investment test to compare the registrant's and its other subsidiaries' investments in and advances to the tested subsidiary to the aggregate worldwide market value of the registrant's voting and non-voting common equity,<sup>1</sup> when available, for acquisitions and dispositions only. If there is no aggregate worldwide market value, the registrant is to use the existing test. The existing test is also to be used in all other circumstances, for example when testing significance of equity method investees under Rules 3-09 and 4-08(g).

The final rules also clarify that for acquisitions, the registrant's and its other subsidiaries' "investments in" the tested subsidiary is the consideration transferred, adjusted to exclude the registrant's and its subsidiaries' proportionate interest in the carrying value of the assets transferred by the registrant and its subsidiaries (consolidated) to the tested subsidiary that will remain with the combined entity after the acquisition. The registrant's and its other subsidiaries' "investments in" the tested subsidiary must include the fair value of contingent consideration if required to be recognized at fair value by the registrant at the acquisition date under U.S. GAAP or IFRS-IASB, as applicable; 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.

For dispositions, the "investments in" the tested subsidiary is the fair value of the consideration, including contingent consideration, for the disposed subsidiary when comparing to the aggregate worldwide market value of the registrant's voting and non-voting common equity or, when the registrant has no such aggregate worldwide market value, the carrying value of the disposed subsidiary when comparing to total assets of the registrant.

The final rules also provide that, for combinations between entities or businesses under common control, the investment test is met when either net book value of the tested subsidiary exceeds 10% of the registrant's and its subsidiaries' consolidated total assets or the number of common shares exchanged or to be exchanged by the registrant exceeds 10% of its total common shares outstanding at the date the combination is initiated.

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<sup>1</sup> The final rules require registrants to use, for purpose of the investment test, the average of aggregate worldwide market value calculated daily for the last five trading days of the registrant's most recently completed month ending prior to the earlier of the registrant's announcement date or agreement date of the acquisition or disposition.

- **The income test.** The income test compares the company's equity in the income from continuing operations of the tested subsidiary, before income taxes, exclusive of amounts attributable to any non-controlling interests, as reflected in its most recent annual pre-acquisition financial statements to the same measure of the registrant as reflected in its most recent annual financial statements required to be filed at or prior to the acquisition. The final rules revise the income test by:
  - adding a new revenue component, which compares a registrant's and its other subsidiaries' proportionate share of the tested subsidiary's consolidated total revenues (after intercompany eliminations) to such consolidated total revenues of the registrant for the most recently completed fiscal year;
  - clarifying the net income component of the test by inserting references to the absolute value of equity in the tested subsidiary's consolidated income or loss from continuing operations; and
  - adopting the use of absolute values for calculating average net income.

The new income test requires that the tested subsidiary meet *both* the new revenue component and the net income component unless either the registrant and its consolidated subsidiaries or the tested subsidiary did not have material annual revenue in each of the two most recently completed fiscal years, in which case the new revenue test will not apply.

The final rules modify the tested subsidiary's consolidated total revenue to clarify that consolidated total revenue refers to consolidated total revenue from continuing operations (after intercompany eliminations). 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.

**Limit the financial statement requirement to a maximum of two years.** The final rules eliminate the requirement to file the third year of Rule 3-05 financial statements for an acquisition that exceeds 50% significance.

The final rules also revise 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 change will allow registrants to avoid including a comparative interim period when only one year of Rule 3-05 audited financial statements is required.

The SEC notes, however, that regardless of the number of years presented, if trends depicted in Rule 3-05 financial statements are not indicative or are otherwise incomplete, Rule 4-01(a) requires that a registrant provide "such further material information as is necessary to make the required statements, in light of the circumstances under which they are made, not misleading."

**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. In these circumstances, making appropriate allocations of the selling entity's overhead and other expenses may be impractical. The final rules permit registrants to provide abbreviated financial statements regarding assets acquired and liabilities assumed if certain qualifying conditions and presentation requirements are met.<sup>2</sup>

**Clarify when financial statements and pro forma information are required.** The final rules 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, or if a business acquisition has occurred or is probable after the date on which the most recent balance sheet has been filed. The final rules 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 notes that it will permit rather than require use of the more recent Form

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<sup>2</sup> The qualifying conditions and disclosure requirements to be met include:

- 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 (as defined in U.S. GAAP or IFRS-IASB, as applicable) 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;
- the balance sheet may be a statement of assets acquired and liabilities assumed;
- the statement of comprehensive income may be a statement of revenues and expenses (exclusive of corporate overhead, interest and income tax expenses) if certain presentation requirements are met;
- the statement of comprehensive income must include expenses incurred by or on behalf of the acquired business during the pre-acquisition financial statement periods to be presented including, but not limited to, costs of sales or services, selling, distribution, marketing, general and administrative, depreciation and amortization, and research and development, but may otherwise omit corporate overhead expenses;
- 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;
- interest tax expense may be omitted; and
- the notes to the financial statements include certain additional disclosures.

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

Additionally, the final rules update certain terminology and language used by revising Rule 3-05 and Article 11, for example, by 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, and replacing references to “business combinations” 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.

***Permit the use of International Financial Reporting Standards.*** The final rules modify 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 remedies 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 as long as the acquired business has a sufficient foreign nexus to meet the definition of foreign private issuer. In circumstances where the registrant presents its financial statements in U.S. GAAP, the pro forma financial information reflecting the acquisition will continue to be required to be presented in U.S. GAAP.

The final rules also 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. Additionally, the final rules permit an acquired business that would qualify as a foreign private issuer if it were a registrant to reconcile to IFRS-IASB rather than U.S. GAAP when the registrant is a foreign private issuer that uses IFRS-IASB.

Finally, the SEC specifies that IFRS 1 will be applicable when reconciling Rule 3-05 financial statements to IFRS-IASB and that Form 20-F accommodations that are inconsistent with IFRS-IASB will not be available when reconciling to IFRS-IASB.

***No longer require separate acquired business financial statements after nine months/one year.*** The final rules specify that a registrant is no longer required to provide acquired business financial statements once the acquired business is reflected in filed post-acquisition registrant financial statements for a complete fiscal year (for acquisitions with significance that exceeds 40%) or nine months (for

acquisitions that are at least 20%, but not more than 40%, significant). 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).

**Expand the 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 final rules permit registrants 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.

The final rules mandate that, when determining significance, the pro forma financial information must be limited to the applicable amounts that combine the historical financial information of the registrant and the acquired business and Transaction Accounting Adjustments (as defined below). The rules further provide that the pro forma financial information that is used to measure significance may only give effect to the subsequently acquired or disposed business and may not give effect to Autonomous Entity Adjustments, Management's Adjustments (each, as defined below), if any, or other transactions, such as the use of proceeds from an offering. Finally, the rules specify that 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.

**Modify 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 amended Rule 3-05(b)(2)(iv), disclosure will 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 amended rule, however, requires 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.

The final rules further clarify that the exception that would otherwise permit pro forma financial information not to be provided when separate financial statements of the acquired business are not included in the filing does not apply where the aggregate impact is significant as determined by amended Rule 3-05(b)(2)(iv) or 3-14(b)(2)(i)(C).

The final rules require registrants to include both Rule 3-05 businesses and Rule 3-14 real estate operations when determining the aggregate impact of the investment test for individually insignificant acquisitions.

***Amend pro forma financial information requirements to improve its relevance.*** Article 11 governs the disclosure requirements for pro forma financial information (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 final rules amend Article 11 by replacing the existing pro forma adjustment criteria with simplified requirements to depict the accounting for the transaction and provide the option to depict synergies and dis-synergies of the acquisitions and dispositions for which pro forma effect is being given. The pro forma adjustment criteria are divided into three categories, the first two of which are required adjustments, while the third is optional:

- “*Transaction Accounting Adjustments*” depict, in the pro forma condensed balance sheet, the accounting for the transaction required by U.S. GAAP or IFRS-IASB and, 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. In other words, these adjustments reflect the application of required accounting to the transaction, linking the effects of the acquired business to the registrant’s historical financial statements.
- “*Autonomous Entity Adjustments*” depict the registrant as an autonomous entity if the registrant previously was part of another entity. Autonomous Entity Adjustments must be presented in a separate column from Transaction Accounting Adjustments.

- “*Management’s Adjustments*” depict synergies and dis-synergies of the acquisitions and dispositions for which pro forma effect is being given that may be presented, in the registrant’s discretion, if, in management’s opinion, such adjustments would enhance an understanding of the pro forma effects of the transaction and certain conditions are met.<sup>3</sup>

**Revise significance threshold for the disposition of a business.** The final rules revise Rule 11-01(b) to raise the significance threshold for the disposition of a business from 10% to 20% to conform to the threshold at which an acquired business is significant under Rule 3-05.

**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.** The final rules align Rule 3-14 with Rule 3-05 in areas where the two Rules diverge in order to reduce complexity by standardizing the requirements for acquired businesses overall while retaining the industry-specific disclosure.

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<sup>3</sup> The conditions require that:

- there is reasonable basis for each adjustment;
- 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;
- 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 disclosed;
- when synergies are presented, any related dis-synergies shall also be presented;
- if presented, the adjustments are presented in the explanatory notes to the pro forma financial information in the form of reconciliations of pro forma net income from continuing operations attributable to the controlling interest and the related pro forma earnings per share data to such amounts, after giving effect to the adjustments;
- if presented, the adjustments included or incorporated by reference into a registration statement, proxy statement, Regulation A offering statement or Form 8-K should be as of the most recent practicable date prior to the effective date, mail date, qualification date or filing date as applicable, which may require that they be updated if previously provided in a Form 8-K that is appropriately incorporated by reference;
- if Management’s Adjustments will change the number of shares or potential common shares, the change must be reflected within Management’s Adjustments in accordance with U.S. GAAP or IFRS-IASB, as applicable, as if the common stock or potential common stock were outstanding as of the beginning of the period presented; and
- 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 the calculation of the adjustment, if material, and the estimated time frame for achieving the synergies and dis-synergies of such adjustment.

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The key amendments aimed at aligning Rule 3-14 with Rule 3-05 include:

- aligning the Rule 3-14 significance threshold for individual acquisitions to the 20% threshold for acquired businesses in Rule 3-05 and for the aggregate impact of acquisitions to the 50% threshold in Rule 3-05;
- eliminating the Rule 3-14 requirement to provide three years of financial statements for acquisitions from related parties;
- 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;
- 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
- 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.

The final rules also amend Rule 3-14 to require the use of a modified investment test when determining whether an acquisition is “significant” since 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.

***Simplify the smaller reporting company requirements.*** The final rules make certain corresponding changes to Rule 8-04 to direct smaller reporting companies to Rule 3-05, other than for form and content requirements for financial statements (which continue to be governed by Rules 8-02 and 8-03).

### **Practical Impact**

The changes to Regulation S-X are part of a disclosure simplification process that has been ongoing for a few years. These changes, while highly technical, will greatly ease some of the more significant burdens associated with presenting financial statements and pro forma financial information in connection with acquisitions by SEC reporting companies. The financial statements of acquired businesses and pro forma information could be included in current reports on Form 8-K or proxy statements, in the case of domestic registrants, or in registration statements. The changes generally will affect the financial statement requirements of Form 8-K and financial statement requirements for Form S-4/F-4 registration statements and proxy statements for subject businesses that *are not* SEC reporting companies.

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The revised tests are intended to reduce anomalous results that have arisen as a result of the mechanical application of the historical tests. For example, the revenue component of the income test potentially will allow a highly leveraged or frequent acquirer to avoid presenting target financial statements that otherwise do not trigger the significance tests. Similarly, the new investment test should benefit “asset light” acquirers. The elimination of the third year of target financial statements, as well as the requirement to provide target financial statements beyond the one year for truly significant acquisitions, will greatly reduce cost and effort.

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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:

Mark S. Bergman  
+44-20-7367-1601

[mbergman@paulweiss.com](mailto:mbergman@paulweiss.com)

John C. Kennedy  
+1-212-373-3025

[jkennedy@paulweiss.com](mailto:jkennedy@paulweiss.com)

Tong Yu  
+81-3-3597-6306

[tyu@paulweiss.com](mailto:tyu@paulweiss.com)

*Securities Practice Management Attorney Monika G. Kislowska contributed to this client alert.*