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May 2020

SEC updates disclosure rules for business acquisitions and dispositions

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On May 20, 2020, the Securities and Exchange Commission (SEC) adopted final amendments relating to the financial disclosure requirements for the acquisition and disposition of businesses, intended to improve the financial information available to investors about acquired or disposed businesses, facilitate more timely access to capital, and reduce the complexity and costs of preparing the disclosure.

The amendments generally modify Rule 3-05 and Article 11 of Regulation S-X as well as other related rules and forms. Rule 3-05 requires a company that acquires a "significant" business to provide separate audited annual and unaudited interim pre-acquisition financial statements of the business. Article 11 requires companies to file unaudited pro forma financial information based on the historical financial statements of the company and the acquired or disposed business. The final amendments also apply to the rules and forms that affect investment companies and real estate operations.

Changes to the rules and forms include amending the significance tests used to determine whether a subsidiary is "significant" and triggers certain disclosures, revising the criteria used to prepare pro forma financial information, and modifying the number of years that financial statements must cover. The final rules are effective on Jan. 1, 2021, but voluntary compliance is permitted before the effective date if the final amendments are applied in their entirety.

Key amendments

The following are key elements of the amendments:

Updated significance tests

These three tests are used to determine whether a business is a "significant subsidiary" and triggers certain disclosure requirements:

1. Investment test.
2. Income test.
3. Asset test.

The amendments substantively revise the investment test and the income test.

As amended, the ***investment test*** compares the company and its other subsidiaries' investments in, and advances to, the tested business to the aggregate worldwide market value of the company's voting and non-voting common equity of the tested business, when available. If the tested business does not have an aggregate worldwide market value, then the existing investment test will apply. This amendment to the investment test only applies to acquisitions and dispositions.

As amended, the ***income test*** includes a new revenue component. The proposed revenue component would compare the company's and its other

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subsidiaries' proportionate share of the tested business's consolidated total revenues (after intercompany eliminations) to such consolidated total revenues of the company for the most recently completed fiscal year.

The revenue component is only applicable if both the company and the tested business had material revenue in the last two fiscal years. Where both the company and the tested business have recurring annual revenue, the tested business must meet both the new revenue component and the net income component in order to be considered significant.

The amended rules allow companies to use the lower percentage of the revenue component and the net income component to determine the periods for which financial statements may be required. The purpose of the amendment is to reduce the frequency of immaterial acquisitions being deemed significant for purposes of the disclosure requirements and to mitigate anomalous results produced by the current test based only on net income.

Additionally, the final amendments conform, to the extent possible, to the significance threshold and tests for disposed businesses to those used for an acquired business.

Number of years for financial statements

The amendments now require that the financial statements of an acquired business cover only up to the two most recent fiscal years, instead of the current requirement of three years. The number of years required depends on the relative significance of the business.

Pro forma financial information

Pro forma financial information, which typically includes the most recent balance sheet and most recent annual and interim period income statements, must accompany any required financial statements of businesses acquired or disposed. Pro forma financials generally include adjustments intended to show how the acquisition or disposition might have affected those financial statements had the transaction occurred at an earlier time. The final amendments replace the existing pro forma adjustment criteria with the following three categories:

- ***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 company's audited historical financial statements. This adjustment is required.
- ***Autonomous entity adjustments*** reflect the operations and financial position of the company as an autonomous entity when the company was previously part of another entity. This adjustment is required.
- ***Management's adjustments*** provide flexibility to companies to depict 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. This adjustment is optional.

Financial statements for acquisitions of components of an entity

The amended rules permit the disclosure of audited, abbreviated financial statements in the form of statements of assets acquired and liabilities assumed, and statements of revenue and expenses (exclusive of corporate overhead, interest and income tax expenses) if a company acquires a component of an entity:

1. That has total assets and total revenues (both after intercompany eliminations) constituting 20 percent or less of such corresponding amounts of the seller in the most recently completed fiscal year and was not a separate entity, subsidiary, segment or division during the period for which financial statements would be required;
2. For which separate financial statements have not previously been prepared; and
3. For which 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.

Examples include a product line or a line of business contained in more than one subsidiary of the selling entity.

Expanded use of pro forma financials to measure significance

The SEC expanded the circumstances when a company can use pro forma financial information to measure significance. If certain conditions are met, a company may now "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." Once a company uses pro forma financial information to measure significance, it must continue to measure significance in this manner until the next annual report.

Omission of financial statements post-acquisition

The amendments revised the extent to which the pre-acquisition financial statements of an acquired business are included in registration statements and proxy statements. The pre-acquisition financial statements may now be omitted once they are included in the acquiring company's audited post-acquisition results for either nine months or a year. The time limit depends on the significance of the acquired business. The amendments also "eliminate the requirement that financial statements be provided when they have not been previously filed or when they have been previously filed but the acquired business is of major significance."

Smaller reporting companies

The SEC also made corresponding changes to the smaller reporting company requirements in Article 8 of Regulation S-X, except for the form and content requirements for the financial statements, which will continue to be prepared in accordance with Article 8. The goal of these revisions is to ease compliance burdens and clarify the application of the rules for smaller reporting companies.