

SEC Adopts Amendments to Improve Financial Disclosures About Acquisitions and Dispositions of Businesses

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On May 21, 2020, the Securities and Exchange Commission announced rule and form amendments that will affect registrants' financial disclosures relating to business acquisitions and dispositions. The amendments are intended to streamline the required disclosures, make more meaningful information available to investors and facilitate access to capital. These amendments mark the culmination of a year-long effort by the SEC that began with proposed rules changes in Release 33-10635, issued on May 3, 2019.

BACKGROUND

In order to ensure that investors are adequately informed of a registrant's important actions, Rule 3-05 of Regulation S-X generally requires a registrant to provide separate financial statements of a business being acquired. The scope of the financial statements depends on the relative "significance" of the acquired business to the registrant, with significance assessed in accordance with asset, investment and income significance tests outlined in Regulation S-K, Rule 1-02(w).^[1]

Article 11 of Regulation S-X requires the registrant to provide pro forma financial information regarding a proposed acquisition or disposition. This usually includes a pro forma balance sheet and pro forma income statement based on the registrant's historical financials, with adjustments to illustrate how the acquisition or disposition might have impacted the historical financials if it had occurred at an earlier date.

HIGHLIGHTS OF AMENDMENTS

Here are some of the most important amendments^[2]:

Update the "significance" test in Rule 1-02(w). These changes accomplish the following:

- Revise the investment test to compare the registrant's investments in (and advances

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to) the acquired business to the registrant's aggregate worldwide market value of its common equity, if available - rather than to its total assets in its most recent annual financial statements; if worldwide market value is not available, the existing test continues to apply;

- Revise the income test to add a revenue component;
- Expand the use of pro forma financial information in determining significance;
- Conform the significance tests for business dispositions to those used for business acquisitions.

Enhance disclosure of the impact of an acquisition for which financial statements are not required.

These amendments eliminate the requirement for historical financial statements for any business that is not "significant." Investors must instead rely on expanded pro forma financial information to assess the impact of the business on the registrant.

Limit required acquired business financial statements to the two most recent fiscal years.

Current rules can require up to three years of acquired business historical financial statements, depending on the significance of the acquisition.

Permit disclosure of "abbreviated" financial statements in certain circumstances when a registrant acquires assets that do not constitute a separate entity, subsidiary, segment or division of the seller.

Registrants often acquire net assets that do not constitute a separate business of the seller. Often these businesses may not have separate financial statements. In those situations, it is often not practicable to prepare financial statements that meet the requirements of Rule 3-05, and the SEC exercised its discretion under Rule 3-13 to permit registrants to provide abbreviated financial statements that do not reflect the allocation of corporate overhead, interest and income tax expenses. This approach is now expressly provided for in Rule 3-05(e) if certain conditions are met.

Eliminate requirement for separate target financials once the acquired business has been included in the registrant's financials for either nine months or a full fiscal year.

Whether the threshold is nine months or a full fiscal year depends on the significance of the acquired business to the registrant. In contrast, current rules can require separate acquired business financials for up to two complete registrant fiscal years after the acquisition has been completed.

Permit the use of, or reconciliation to, International Financial Reporting Standards in certain circumstances.

The International Financial Reporting Standards ("IFRS"), as issued by the International Accounting Standards Board, are the global equivalent of U.S. Generally Accepted

Accounting Principles (“GAAP”). They are used in more than 120 countries, with a noteworthy exception of the United States. For acquisitions on non-US companies, U.S. registrants will have the ability to rely on financial statements prepared in accordance with IFRS in certain circumstances.

Amend pro forma information requirements to improve their content and relevance.

The pro forma information required by Article 11 of Regulation S-K generally includes certain adjustments to illustrate how an acquisition or disposition might have impacted the registrant’s historical financials if it had occurred earlier. A narrow range of adjustments is allowed for income statements, while a broader range of adjustment is permitted for balance sheets. The SEC has revised Article 11 to replace the existing pro forma adjustment criteria with the following adjustments:

- “Transaction Accounting Adjustments,” which reflect only the application of required accounting principles to the transaction, linking the effects of the acquired business to the registrant’s audited historical financial statements;
- “Autonomous Entity Adjustments,” which reflect the operations and financial position of the registrant as an autonomous entity, if the registrant was previously part of another entity;
- Optional “Management’s Adjustments,” to reflect synergies (or lack of synergies) of an acquisition or disposition if, in management’s opinion, such adjustments will enhance an understanding of the pro forma effects of the transaction. To take advantage of Management’s Adjustments, the registrant must adhere to certain conditions related to the basis and form of presentation of the pro forma information.

Make corresponding changes to the smaller reporting company requirements in Article 8 of Regulation S-K.

The changes to SRC requirements will also apply to any issuer relying on Regulation A.

EFFECTIVE DATE OF AMENDMENTS; MORE INFORMATION

The amendments will be effective January 1, 2021, but voluntary early compliance is permitted. The full text of the final rules can be found at <https://www.sec.gov/rules/final/2020/33-10786.pdf>

[1] Special rules apply to acquisitions of real estate operations, which are governed by Rule 3-14 rather than Rule 3-05. Amendments to Rule 3-14 are beyond the scope of this post.

[2] Many of the amendments impact acquisitions involving registered investment companies and business development companies. The amendments as they relate to registered investment companies and business development companies are beyond the scope of this post.