

## SEC Updates Rules for Financial Statements for M&A

The U.S. Securities and Exchange Commission on May 21, 2020, [adopted amendments](#) to Regulation S-X (Reg S-X) for financial statements related to acquisitions and dispositions of businesses. SEC Chairman Jay Clayton [stated that](#) the amendments are intended to "enhance the quality of information that investors receive while eliminating unnecessary costs and burdens," by assisting SEC-registered companies, or registrants, in making determinations of whether a subsidiary or an acquired or disposed business is "significant," and improving the financial disclosure requirements that apply to acquisitions and disposition of businesses. These amendments will take effect January 1, 2021, but the SEC will permit voluntary compliance in advance of that date.

Most notably, the final rules amend the significance tests for determining whether, and to what extent, a registrant must disclose financial statements on the acquisition or disposition of a business. These amendments to the significance tests include changes that are intended to eliminate some of the anomalous outcomes that have occurred under the current rules, requiring burdensome financial statement disclosures for acquisitions and dispositions that are otherwise immaterial.

The SEC summarized the amendments as follows:

- Update the significance tests under Reg S-X Rule 1-02(w) and related rules and forms to generally improve their application and assist registrants in making more meaningful significance determinations
- Expand the use of pro forma financial information in measuring significance
- Conform, to the extent applicable, the significance threshold and tests for disposed businesses to those used for an acquired business
- Require the financial statements of the acquired business to cover only up to the two most recent fiscal years
- Permit disclosure of abbreviated financial statements for certain acquisitions of a component of an entity
- Permit the use of, or reconciliation to, International Financial Reporting Standards as issued by the International Accounting Standards Board (IFRS-IASB) in certain circumstances
- No longer require separate acquired business financial statements once the business has been included in the registrant's post-acquisition financial statements for either nine months or a complete fiscal year, depending on significance
- Modify and enhance the required disclosure for the aggregate effect of acquisitions for which financial statements are not required or are not yet required
- Align Reg S-X Rule 3-14 with Rule 3-05 where no unique industry considerations exist
- Clarify the application of Reg S-X Rule 3-14 regarding the determination of significance, the need for interim income statements, special provisions for blind pool offerings, and the scope of the rule's requirements
- Amend the pro forma financial information requirements to improve the content and relevance of such information
- Clarify when financial statements and pro forma financial information are required, and update the language used in the rules to take into account concepts that have developed since adoption of the rules over 30 years ago
- Make corresponding changes to the smaller reporting company requirements in Article 8 of Reg S-X

## Summary of Amendments

Below we provide a brief summary of the most significant rule amendments applicable to operating companies, along with the currently applicable rule. The amendments also made conforming and other amendments to the rules on acquisitions and dispositions of real estate operations, and rules applicable to investment companies, foreign businesses, and smaller reporting companies, which are not detailed here.

The SEC's Division of Corporation Finance also continues to be open to requests from companies under Reg S-X Rule 3-13 to omit or substitute one or more required financial statements in unique circumstances where such omission or substitution is consistent with the protection of investors.

### Applicable Rules Current Rule

### Amendments

#### Significant Subsidiary: Investment Test

Reg S-X Rule 1-02(w)

**Compared Against Total Assets.** The investment test compares the registrant's investments in and advances to the subsidiary in question (for an acquisition, the consideration paid) to the total assets of the registrant and its subsidiaries consolidated as shown at the end of the most recently completed fiscal year, or in the case of an acquired business, in the registrant's most recent annual financial statements required to be filed at or prior to the acquisition date.

**Compared Against Aggregate Worldwide Market Value.** For acquisitions and dispositions, compares the registrant's investments in and advances to the subsidiary in question against the aggregate worldwide market value of the registrant's voting and non-voting common equity (when available). If the registrant does not have an aggregate worldwide market value, total assets is used.

This amendment reflects the fact that a purchase or sale price generally reflects fair value, while total assets are measured at book value. Using worldwide market value addresses this mismatch.

#### Significant Subsidiary: Investment Test

Reg S-X Rule 1-02(w)

**"Investments In" Subsidiary Determined Under GAAP.** In determining the "investments in" the tested acquired business, uses the purchase price as determined under applicable accounting standards, with certain adjustments.

**"Investments In" Subsidiary Include Contingent Consideration for Acquisition or Disposition.** For acquisitions, requires inclusion of fair value of contingent consideration if required to be recognized at fair value under applicable accounting standards. If recognition of fair value is not required, requires inclusion of all contingent consideration, except that for which likelihood of payment is remote.

For dispositions, requires inclusion of fair value of contingent consideration.

These amendments are intended to avoid underidentification of acquisitions that could materially affect the registrant's financial statements.

## Applicable Rules Current Rule

## Amendments

### Significant Subsidiary: Income Test

Reg S-X Rule 1-02(w); New Reg S-X Rule 3-05(b)(2)

**No Revenue Component.** Compares the registrant's equity in the tested subsidiary's income from continuing operations before income taxes (exclusive of amounts attributable to any noncontrolling interests) to such income of the registrant.

**Revenue Component.** The new revenue component of the income test requires the registrant to compare the subsidiary's revenue to that of the registrant and its other subsidiaries in order to reduce anomalous results under the income test for registrants with marginal or break-even net income or a loss in a recent fiscal year.

To be "significant," the tested subsidiary must meet both the revenue component *and* the net income component, when the revenue component applies.

With respect to significance of an acquired business, the tested subsidiary may use the *lower* of the revenue component and the net income component for purposes of determining the periods for which Rule 3-05 financial statements are required.

The revenue component does not apply if either the registrant and its consolidated subsidiaries or the tested subsidiary did not have material revenue in each of the two most recently completed fiscal years.

### Pro Forma Financial Information: Significance and Business Dispositions

Reg S-X Rule 11-01(a)(4); Reg S-X Rule 11-01(b)

#### **Threshold for Significance of Business**

**Disposition is 10%.** A disposition of a business is significant if the business to be disposed of meets the conditions of a significant subsidiary under Rule 1-02(w). Rule 1-02(w) uses a 10% significance threshold, rather than the 20% threshold used for business acquisitions under Rules 3-05 and 11-01(b).

#### **Threshold for Significance of Business**

**Disposition is 20%.** Raises the significance threshold for the disposition of a business from 10% to 20% and conforms, to the extent applicable, the tests used to determine significance of a disposed business to those used to determine significance of an acquired business.

## Applicable Rules Current Rule

## Amendments

### Years of Financial Statements for Significant Acquisitions

Reg S-X Rule 3-05

**Three-Year Maximum.** Rule 3-05 financial statements may be required for up to three years, depending on the relative significance of the target business acquired (or to be acquired).

**Two-Year Maximum.** The amendments reduce the maximum period for Rule 3-05 financial statements to two years. For businesses acquired or to be acquired whose significance under any of the tests exceeds 40%, two years of the required financial statements are required.

### Interim Period Financial Statements for Significant Acquisitions

Reg S-X Rule 3-05(b)(2)

**Corresponding Interim Period for Preceding Year Required.** Interim financial statements are required for any interim period, and the corresponding interim period of the preceding year.

**Most Recent Interim Period Only if One Year of Audited Financial Statements Required.** The amendments also remove the requirement to provide the corresponding interim year period for an acquired company where any test measures 20%, but none more than 40%. This amendment eliminates the need to provide a comparative interim period when only one year of audited financial statements is required.

### Financial Statements for Business Components

New Reg S-X Rule 3-05(e)

**No Exception to Financial Statements for Net Assets that Constitute a Business.** When a registrant acquires a component of a business, rather than a separate entity, subsidiary, or division (such as a product line), separate financial statements may not be available, as the component may represent only a small portion of the selling entity. In these circumstances, the SEC staff has historically permitted registrants to provide audited abbreviated financial statements, but Reg S-X does not expressly address the situation.

**Registrants May Submit Abbreviated Financial Statements for Qualifying Business Components.** To assist with the difficulty in providing Rule 3-05 financial statements in these circumstances, the amendments allow for abbreviated financial statements including a statement of assets acquired and liabilities assumed, and a statement of revenues and expenses. To qualify, the acquired business must constitute 20% or less of total assets and total revenues of the seller and its consolidated subsidiaries, and must not have been a separate entity, subsidiary, operating segment or division, must not have had separate financial statements previously prepared, and the seller must not have maintained the accounts necessary to present the generally required financial statements.

## Applicable Rules Current Rule

## Amendments

### Rule 3-05 Financial Statements in Registration and Proxy Statements

Reg S-X Rule 3-05(b)

**Rule 3-05 Financial Statements May Be Omitted After Reflected in Registrant's Financial Statements for a Complete Fiscal Year.** Generally permits Rule 3-05 financial statements to be omitted from proxy statements and registration statements (other than in cases where an offering of securities is made to the security holders of the company to be acquired) once the operating results of the acquired business have been reflected in the audited consolidated financial statements of the registrant for a complete fiscal year, unless the financial statements have not been previously filed or the acquired business is of major significance to the registrant.

**May Be Omitted After Reflected in Registrant's Financial Statements for Nine Months if Business Does Not Exceed 40% Significance.** Allows omission of pre-acquisition financial statements for businesses that exceed 20% but do not exceed 40% significance once they are included in the registrant's post-acquisition results for nine months. For businesses that exceed 40% significance, allows omission once they are included in the registrant's post-acquisition results for a complete fiscal year.

Eliminates the requirement that Rule 3-05 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.

### Use of Pro Forma Financial Information to Measure Significance

Reg S-X Rule 3-05(b)(3); Rule 11-01(b)(3)

**Pro Forma Financial Information May Be Used to Test Significance of Acquisitions After the Latest Fiscal Year End.** Registrants are permitted to use pro forma financial information to test significance of a subsequently acquired business if the registrant made a significant acquisition after the latest fiscal year end and filed its Rule 3-05 financial statements and pro forma financial information on Form 8-K.

This Form 8-K filing requirement effectively precludes a company in the process of going public from using such pro forma financial information to test significance of a subsequently acquired business for an initial registration statement.

Reg S-X does not provide for dispositions of significant businesses to be included in the pro forma financial information used for testing significance of a subsequently acquired or subsequently disposed business.

**Pro Forma Financial Information May Be Used to Test Significance of Acquisitions and Dispositions After the Latest Fiscal Year End.** Permits 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 (and not certain other adjustments) as long as the registrant has filed the applicable Rule 3-05 or Rule 3-14 financial statements for such acquisitions and Article 11 pro forma financial information for such acquisitions or dispositions.

In the adopting release for the amendments, the SEC stated that these revised conditions, without reference to Form 8-K, clarify that if the required financial statements and pro forma financial information are included in an initial registration statement, then the pro forma information may be used to measure significance of a subsequent acquisition.

## Applicable Rules Current Rule

## Amendments

### **Rule 3-05 Financial Statements Not Required for Acquired Businesses Whose Significance Do Not Exceed 20%. Pro Forma Financial Information Must Depict Aggregate Effects of All Individually Insignificant Businesses.**

Requires disclosure 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 or are not yet required, exceeds 50% for any condition.

Clarifies that "individually insignificant businesses" include:

- 1) Any acquisition consummated after the registrant's audited balance sheet date whose significance does not exceed 20%
- 2) Any probable acquisition whose significance does not exceed 50%
- 3) Any consummated acquisition whose significance exceeds 20%, but does not exceed 50%, for which financial statements are not yet required by Rule 3-05(b)(4) because of the filing grace period

Requires registrants to provide pre-acquisition historical financial statements only for those businesses whose individual significance exceeds 20%.

Requires registrants to provide pro forma financial information depicting the aggregate effects of all "individually insignificant businesses" in all material respects.

### **Rule 3-05 Financial Statements Required for Majority of Acquired Individually Insignificant Businesses if Aggregate Impact Exceeds 50%.**

Audited historical pre-acquisition financial statements are generally not required for individually insignificant acquired businesses.

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. Related pro forma financial information also required.

### **Disclosure Requirements for Individually Insignificant Acquisitions**

Reg S-X Rule 3-05(b)(2)

## Applicable Rules Current Rule

## Amendments

### Pro Forma Financial Information: Adjustment Criteria and Presentation Requirements

Reg S-X Rule 11-02

**No Management Adjustments to Pro Forma Financial Information.** The rules for presentation of pro forma financial information are generally designed to provide disclosures that distinguish between the one-time impact and the ongoing impact of a transaction. The pro forma condensed statement of comprehensive income may include only adjustments that are directly attributable to the transaction; expected to have a continuing effect on the registrant; and factually supportable.

The pro forma condensed balance sheet reflects pro forma adjustments that are directly attributable to the transaction and factually supportable, regardless of whether the impact is expected to be continuing or nonrecurring, as the objective of the pro forma balance sheet is to reflect the impact of the transaction on the financial position of the registrant as of the balance sheet date.

### Management Adjustments Permitted, and Further Clarification of Required Adjustments.

The amendments are intended to simplify the requirements for accounting for the transaction and provide the option to depict synergies and dis-synergies of the acquisitions and dispositions. The revised pro forma adjustment criteria are organized into three categories of Transaction Accounting Adjustments, Autonomous Entity Adjustments, and Management's Adjustments.

Transaction Accounting Adjustments and Autonomous Entity Adjustments are required, while Management's Adjustments are optional and may be presented if, in management's opinion, such adjustments would enhance an understanding of the pro forma effects of the transaction.

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