

SEC UPDATES RULES ON FINANCIAL DISCLOSURES FOR BUSINESS ACQUISITIONS AND DISPOSITIONS

Hodgson Russ Securities Regulation & Corporate Compliance Alert
June 5, 2020

On May 21, 2020, the Securities and Exchange Commission finalized and adopted its eagerly awaited revisions to Regulation S-X with respect to financial disclosures for business acquisitions and dispositions. While many of the revisions are quite technical in nature, they have the overall general effect of reducing the burden of preparing historical financial statements and pro forma financial information. Among the useful changes made by these revisions are:

- Reducing the maximum period for which historical financial statements of an acquired business must be provided from the prior three fiscal years down to the prior two fiscal years (in addition to any required interim periods);
- Allowing the use of “abbreviated financial statements” that do not require corporate-level allocations in lieu of full historical financial statements for certain carve-out transactions;
- Increasing the significance thresholds for dispositions from 10% to 20%;
- Changing the tests used to determine the significance of an acquisition or disposition in order to seek to avoid disclosure regarding non-material transactions;
- Permitting the use of “management adjustments” that reflect estimable synergies and other effects of a transaction in the preparation of pro forma financial information; and
- Providing certain additional accommodations for foreign acquired businesses.

Effective Date

These rule amendments, as described in greater detail below, will go into effect beginning on January 1, 2021. However, registrants are permitted to use the amended rules effective immediately, but must comply with these revisions in their totality during the period prior to January 1, 2021 and are not permitted to implement only the beneficial elements.

Attorneys

Catherine Grantier Cooley
Craig Fischer
Kenneth Friedman
Cristin Murray
John Zak
Benjamin Zuffranieri Jr.

Practices & Industries

Business Litigation
Corporate Governance & Compliance
Investment Management & Compliance
Securities Regulation & Corporate Compliance
Securities/Directors & Officers Litigation

Periods for which Historical Financial Statements Must be Presented

Under the prior rules, an acquisition that exceeded any of the significance tests at a 50% or greater significance level resulted in the need to provide three years of historical financial statements for the acquisition target. Under the revised rules, the requirement to provide the earliest of the three years has been eliminated. As a result, the revised rules require presentation of (i) two years of historical financial statements if the acquisition is significant at a 40% or greater level or (ii) one year of historical financial statements if the acquisition is significant at a greater than 20% level but less than 40% level.

The revisions also eliminate the need to provide the prior corresponding interim period income statement (but retain the requirement to provide the current year interim period income statement) if only one year of historical financial statements is required to be provided. However, if two years of historical financial statements must be provided, the rules still require presentation of both the current year and prior year interim period income statements.

Notwithstanding these changes to Regulation S-X, the financial statement requirements of Form S-4 or F-4, as may be applicable, will still determine what historical financial statements must be provided for the target company in a business combination registration statement.

“Abbreviated Financial Statements” for Certain Carve-Out Transactions

When acquiring a line of business or product line in a “carve-out” transaction, the preparation of historical financial statements for the carve-out business can often be difficult since it requires the allocation of corporate overhead expense, interest expense and income tax expense to the carve-out business. The revised rules allow a registrant to provide “abbreviated financial statements” consisting of audited statements of assets acquired and liabilities assumed and statements of revenue and expenses that exclude allocations of overhead, interest and income tax expense if certain conditions are met, as specified in new Rule 3-05(e) of Regulation S-X. Most notably, the total assets and revenues of the carve-out business acquired must consist of 20% or less of the total assets and revenues of the seller and its subsidiaries. As part of the presentation of the “abbreviated financial statements,” the notes to these financial statements must include, among other things, a description of the omitted expenses and the reason they were excluded.

Dispositions – Significance Thresholds

In connection with a disposition, seller is required to provide pro forma financial information for any disposition that exceeds any of the significance tests. Under the prior rules, the threshold for significance with respect to a disposition was 10%. The revised rules have raised the significance threshold to 20%.

Changes to Significance Tests

Rule 1-02(w) of Regulation S-X provides three separate tests for use in determining whether an acquisition or disposition is significant. These tests consist of (i) an *investment test* comparing, under the prior rules, investments in or advances to a target to the assets of the registrant, (ii) an *income test* comparing, under the prior rules, pre-tax income of the target to the pre-tax income of the registrant and (iii) an *asset test* comparing asset of the target to assets of the registrant.

SEC UPDATES RULES ON FINANCIAL DISCLOSURES FOR BUSINESS ACQUISITIONS AND DISPOSITIONS

- **Changes to Investment Test** – The denominator used under the investment test is revised from total assets to the market value of the registrant’s equity, where ascertainable. Under this revised test, the market value of the registrant’s equity is calculated as the average “aggregate worldwide market value” of the registrant’s voting and non-voting common equity calculated daily for the last five trading days of the registrant’s most recently completed month ending prior to the earlier of the announcement date or agreement date of the acquisition or disposition. If market value of equity is not ascertainable, the existing element of the denominator (assets of the registrant) is to be used. In addition, for purposes of calculating the numerator (investments in or advances to the target), the investment amount of the acquired business must include the fair value of any contingent consideration to be paid.
- **Changes to Income Test** – Significance is now required to be met, subject to certain exceptions, under both the current pre-tax income comparison and a new revenue comparison (if both the target and the registrant have material annual revenues for the prior two years). Under this revenue component, the revenues of the target (after intercompany eliminations) are compared to the total revenues of the registrant. Significance is achieved under the income test only if both the pre-tax income comparison and the revenue comparison are above the 20% threshold. The lower of the significance determination under the revenue comparison and the pre-tax income comparison would then be used to determine the period for which historical financial information must be provided.
- **Expanded Use of Pro Forma Financial Information to Determine Significance** – The prior rules only allowed use of pro forma financial information to determine significance in connection with a significant acquisition that occurred subsequent to the last fiscal year end and for which the registrant had filed historical financial statements and pro forma financial information. The revised rules expand the circumstances for which pro forma financial information can be used to determine significance to include significant dispositions that have occurred subsequent to the last fiscal year end and for which pro forma financial information has been filed. In allowing use of pro forma financial information to determine significance, the revised rules only permit the use of “transaction accounting adjustments” and not the use of “management adjustments” or “autonomous entity adjustments,” each as described in greater detail below. In addition, once pro forma financial information has been used to determine significance, a registrant must continue to use pro forma financial information until its next annual report.

Preparation of Pro Forma Financial Information

Pro forma financial information for an acquisition or disposition generally consists of a balance sheet as of the end of the most recently completed period and annual and interim period income statements. Under the prior rules, pro forma adjustments were permitted to be made if they were factually supportable, directly attributable to the transactions and, with respect to income statement adjustments, expected to have a continuing impact on the registrant. These adjustment criteria have been replaced with the following three categories of adjustments: (i) *transaction accounting adjustments* (mandatory) – consisting of adjustments required to reflect the accounting for the transaction and required regardless of whether the impact is expected to be continuing or not; (ii) *autonomous entity adjustments* (mandatory) – consisting of adjustments necessary to reflect the operations and financial position of the registrant as an autonomous entity when the registrant was previously part of another entity; and (iii) *management’s adjustments* (optional) – consisting of information indicating synergies, dis-synergies and other effects of the transaction as determined by management. Management’s adjustments are encouraged but not required to be presented and may only be presented if specified conditions regarding the adjustments are

SEC UPDATES RULES ON FINANCIAL DISCLOSURES FOR BUSINESS ACQUISITIONS AND DISPOSITIONS

met. In addition, management's adjustments are only to be presented in the explanatory notes to the pro forma financial information in the form of reconciliations to 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 "management's adjustments." This presentation requirement for management's adjustments was included so as to allow for consistency between pro forma financial information presentations that include management's adjustments and those that do not.

Financial Information of Foreign Acquired Businesses

The revised rules provide two helpful revisions that are applicable to foreign acquired businesses:

- If the foreign acquired business would meet the qualifications to be a foreign private issuer if it were the registrant, the historical financial statements of the foreign acquired business can be presented under IFRS without the need to present a reconciliation to U.S. GAAP. This accommodation applies even if the registrant itself presents its financial statements in accordance with U.S. GAAP. However, any pro forma financial information for the acquisition must still be presented in accordance with U.S. GAAP.
- If the registrant is a foreign private issuer that prepares its financial statements in accordance with IFRS, it is permitted to reconcile the historical financial statements of any foreign business that is acquired which prepares its financial statements in accordance with home country GAAP to IFRS. Under the prior rules, these historical financial statements of the foreign business prepared in accordance with home country GAAP were required to be reconciled to U.S. GAAP, which was an anomalous result.

If you have any questions about the SEC's revisions to Regulation S-X as described in this alert or otherwise need assistance complying with Regulation S-X and the SEC rules applicable to financial disclosures for business acquisitions and dispositions, please contact John J. Zak (716.848.1253) or Craig M. Fischer (716.848.1266).

Please check our Coronavirus Resource Center and our CARES Act page to access information related to both of these rapidly evolving topics.

If you received this alert from a third party or from visiting our website, and would like to be added to any of our mailing lists, please visit us [HERE](#).