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# To the Point

**SEC — final rule**

## SEC streamlines disclosure requirements for acquisitions and disposals of businesses

The final rules are designed to enhance the quality of information that investors receive while eliminating unnecessary costs and burdens for preparers.

### What you need to know

- The SEC revised the significance tests registrants use to determine the required disclosures for acquisitions and disposals of businesses. The new investment test considers the registrant's market capitalization, and the new income test adds consideration of the revenue of the registrant and the acquired business. The SEC also increased the significance threshold to report business disposals to 20% from 10%.
- The SEC formalized existing practice by allowing registrants to provide abbreviated financial statements of acquired businesses that meet certain criteria.
- The revised rules require registrants to present a maximum of two years of audited financial statements of an acquired business rather than three years, and they allow registration statements to exclude pre-acquisition financial statements of acquired businesses in certain cases.
- The SEC simplified pro forma financial reporting by redefining pro forma adjustments as those necessary to reflect the accounting for the transaction. But registrants can elect to disclose forward-looking adjustments that meet certain criteria.
- The rules are effective 1 January 2021, but earlier compliance is permitted.

## Overview

The Securities and Exchange Commission (SEC) adopted **final rules** that amend its requirements for registrants to provide information about significant business acquisitions and disposals. The amendments change the significance tests used to determine whether registrants need to

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file audited financial statements of the acquired business and related pro forma financial information, the periods those financial statements must cover, and the form and content of the pro forma financial information.

The final rules were adopted as part of the SEC's disclosure effectiveness initiative. SEC Chairman Jay Clayton said they are designed "to enhance the quality of information that investors receive while eliminating unnecessary costs and burdens" and predicted that they "will benefit investors, registrants and the market more generally."

## Key considerations

### Revised significance tests

The amendments revise the investment and income tests in Rule 1-02(w) of Regulation S-X that are used to determine whether a registrant needs to file audited financial statements (and related pro forma financial information) of a business it acquires and, if so, how many periods must be presented.

The investment test was revised to compare the fair value of the purchase consideration transferred to an average aggregate worldwide market value of the registrant's voting and non-voting common equity (WWMV). The WWMV is calculated using the last five trading days of the registrant's most recently completed month ended before the earlier of its announcement of the transaction or the agreement date. A registrant's total assets will still be used when its common equity is not publicly traded, including for the purposes of an initial public offering.

The income test was revised to add a revenue component that compares the most recent annual revenue of the acquired business to that of the registrant. The income test also still compares pretax income from continuing operations of the acquired business to that of the registrant. Significance is measured using the lower result of the two components.

The revenue component of the test is performed only when the acquired business and the registrant had material revenue during each of the past two fiscal years. The SEC did not revise the income test to use after-tax income, as it had proposed. The revised income test is also used to determine the significance of investees accounted for using the equity method or the fair value option for purposes of Rules 3-09 and 4-08(g) of Regulation S-X.

The amendments also raise the significance threshold for Form 8-K reporting of businesses that are disposed to 20% from 10% to align with the requirements for reporting business acquisitions.

## How we see it

Registrants will need to apply judgment when determining whether material revenue was recognized during the two most recently completed fiscal years. That is, a registrant must evaluate, quantitatively and qualitatively, whether the revenue recorded by the acquired business during the two most recent fiscal years was material to that business. A similar analysis must be performed for the registrant.

### Expanded use of abbreviated financial statements

The SEC adopted new S-X Rule 3-05(e) to allow registrants to provide, without approval from the SEC staff, abbreviated financial statements when an acquired business was part of a larger selling entity and all the following conditions are met:

- The total assets and total revenue (after intercompany eliminations) of the acquired business constitute no more than 20% of the total assets and total revenue of the seller for the most recently completed fiscal year.

- The acquired business was not a separate entity, subsidiary, operating segment (as defined by US GAAP or IFRS) or division during the periods for which financial statements are required.
- Separate financial statements for the business have not previously been prepared, the seller has not maintained the separate accounts necessary to present full financial statements of the business, and it is impracticable to prepare such financial statements.

The abbreviated financial statements must include substantially all expenses incurred by or on behalf of the acquired business during the pre-acquisition financial statement periods to be presented. The statements must include costs of sales or services, selling, distribution, marketing, general and administrative, depreciation, amortization and research and development expenses, but they may exclude corporate overhead allocations.

The notes to the abbreviated financial statements must identify the omitted expenses and the reason for the omission. A registrant must also disclose that the statements are not indicative of the future financial condition or operating results of the acquired business, and it must provide any available information about the operating, investing and financing cash flows of the acquired business.

The SEC didn't address when it would be appropriate for a registrant that acquires a business that was a larger part of the seller (i.e., more than 20% but less than substantially all of the assets and revenue of the seller) to present carve-out financial statements. The SEC said only that questions about carve-out financial statements should be directed to the SEC staff because they may entail unique judgments.

The amendments also include new S-X Rule 3-05(f) that allows a registrant to present abbreviated financial statements of an acquired business engaged in oil and gas producing activities, which must include certain industry-specific disclosures specified in Financial Accounting Standards Board Accounting Standards Codification Topic 932, *Extractive Activities — Oil and* Gas.

## How we see it

These changes will significantly reduce the frequency with which registrants must request permission from the SEC staff to present abbreviated financial statements. Registrants must continue to do so when they believe it is impracticable to prepare full financial statements for an acquired business that was an operating segment, subsidiary or division of the seller. Registrants must also continue to do so when the revenue and/or assets of the acquired business exceed the new 20% bright-line threshold.

### Reduced number of audited and interim periods

The amendments eliminated requirements that registrants provide three years of audited financial statements for an acquisition that exceeds 50% significance. The 20% and 40% significance thresholds for one- and two-year presentations remain unchanged. The SEC also eliminated the requirement that registrants provide comparative unaudited interim financial statements for the prior year when only one year of audited financial statements is required.

### Reduced requirements for registration statements

The SEC eliminated any requirement for registration statements to include audited pre-acquisition financial statements of an acquired business that exceeds 20% significance, but not 40% significance, if the acquired business has already been included in the registrant's audited results for at least nine months. A registration statement can omit the financial statements of an acquired business that exceeds 40% significance if the acquired business has been included in the registrant's audited results for a full fiscal year.

The amendments also replaced the requirement that registration statements include audited financial statements and pro forma financial information for the "mathematical majority" of the individually insignificant acquisitions that are 50% significant in the aggregate. Instead, registration statements must include only the audited financial statements of acquisitions that individually exceed 20%, along with pro forma financial information about the aggregate impact of all the acquisitions, in all material respects.

## How we see it

These changes should significantly reduce the cost and financial reporting burden of going public for companies that have grown through acquisitions.

### Revised pro forma financial information

The SEC eliminated the prescriptive legacy criteria for making pro forma adjustments and required two categories of adjustments: (1) transaction accounting adjustments that reflect the accounting for the transaction under US GAAP or IFRS and (2) autonomous entity adjustments that are needed when a new registrant is being spun off from a larger entity. The SEC also gave management the option to provide a third category of adjustments that include forward-looking information (e.g., expected synergies) that have "a reasonable basis" and are necessary for a "fair presentation."

Management has the option to include forward-looking adjustments in pro forma financial information.

The transaction accounting and autonomous entity adjustments must be shown in two separate columns while management's adjustments, if presented, would appear only in the explanatory notes to the pro forma financial information.

## How we see it

By eliminating the legacy criteria, nonrecurring effects of the transaction accounting will now be included in the pro forma financial information (e.g., nonrecurring compensation charges resulting from change-in-control provisions.)

### Other changes

The amendments align key provisions of Rule 3-14 regarding significant acquired real estate operations with the changes to Rule 3-05. For example, the significance threshold is increased to 20% from 10%, and the requirement to provide additional years of financial statements for a real estate operation acquired from a related party is eliminated.

The SEC also expanded the ability of registrants to provide financial statements of certain acquired businesses using either IFRS without a reconciliation to US GAAP or home-country accounting principles reconciled to IFRS.

The requirements for smaller reporting companies and Regulation A issuers were also conformed, but the form and content of their financial statements continues to be dictated by Article 8 of Regulation S-X. The SEC also made a number of changes to address acquisitions involving investment companies, including adopting new Rule 6-11 and amending Form N-14.

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