SEC Adopts Amendments to Financial Statement and Pro Forma Requirements in Connection with Acquisitions and Dispositions of Businesses

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Client Alert

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On May 21, 2020, the Securities and Exchange Commission (SEC) adopted amendments (the “Amendments”) that are intended to simplify the determination of whether financial statements are required in connection with an acquisition or disposition of a business, and to improve the financial disclosures related to such transactions. As we previously discussed here, the SEC proposed these amendments in May 2019 to improve the quality of information available to investors in evaluating the impact of acquisitions or dispositions, and to reduce the complexity of complying with the applicable rules, thereby facilitating timely access to capital. The Amendments have been adopted largely as they were proposed, but with a few modifications. The Amendments go into effect on January 1, 2021, but voluntary compliance will be permitted in advance of this date. The final Amendments can be found here.
When a registrant completes an acquisition, or when an acquisition is probable, it may be required to file separate audited annual and unaudited interim historical financial statements of the acquired business (the Historical Financial Statements), depending on the acquisition’s significance under Rule 1-02(w) of Regulation S-X (collectively, the Significance Tests). Additionally, Article 11 of Regulation S-X requires unaudited pro forma financial information, which combines the Historical Financial Statements of the registrant with those of the acquired business, reflecting the effect of any significant acquisition or disposition (Pro Formas). Among other things, the Amendments make changes to the Significance Tests and to the required periods of Historical Financial Statements, and certain other changes intended to simplify the presentation of Historical Financial Statements and Pro Formas in connection with acquisitions and dispositions.

Significance Tests

A registrant evaluates the significance of an acquisition or a disposition using three Significance Tests: the investment test, the income test, and the asset test. The Amendments revised two of the three Significance Tests (the investment test and the income test).

First, the investment test, which currently compares the registrant’s investments in or advances to the entity being acquired against the registrant’s total assets, will instead compare the registrant’s investments in or advances to the entity being acquired against the aggregate worldwide market value of the registrant’s voting and nonvoting common stock, if available. In the absence of a market value, the comparison will continue to be based on the registrant’s total assets. In calculating aggregate worldwide market value, a registrant is required to use the average aggregate worldwide market value calculated daily for the last five trading days of the registrant’s most recently completed month ending prior to the earlier of the registrant’s announcement date or agreement date of the acquisition or disposition. This change is intended to better reflect the economic impact of the transaction on the registrant. The Amendments also provide clarification on calculating the “investment in” the business acquired or disposed, and address contingent consideration such as earnouts or milestone payments.

Second, the Amendments revised the income test. Under the current income test, the registrant’s income from and the acquired entity’s income from continuing operations before taxes, extraordinary items, and cumulative effects of changes in accounting principles are compared for the most recently completed fiscal year. The Amendments add a new revenue component to the income test, which is intended to address the impact on the income test of unusual expenses, gains, or losses that would impact the income test, and in some cases, require filing financial statements for relatively small acquisitions. For the new revenue component, the revenues of the acquired entity will be compared with the revenues of the registrant for its most recently completed fiscal year in cases where both entities have recurring annual revenue. If neither the registrant nor the acquired entity had material recurring revenue in each of the two most recently completed fiscal years, the revenue component of the income test would not apply and the registrant would use only the
net income component of the test. In cases where the revenue component applies, the registrant is permitted to use the lesser percentage of the two components of the income test in assessing the significance level to determine the periods of Historical Financial Statements that the registrant is required to file.

The asset test, which compares the registrant’s share of the acquired business’s total assets to the registrant’s consolidated total assets, remains substantively unchanged under the Amendments. However, a number of non-substantive revisions were proposed and adopted.

**Required Periods of Historical Financial Statements**

The significance level under the Significance Tests above determines the periods of Historical Financial Statements that a registrant is required to file. The thresholds for acquisitions remain unchanged under the Amendments (less than 20%, 20% to 40%, 40% to 50%, and greater than 50%), and the significance level is the greatest one of the three Significance Tests.

Under the prior rules, audited annual Historical Financial Statements of up to the three prior years could be required if any of the Significance Tests exceeded the 50% level. Under the Amendments, no more than two years of audited annual Historical Financial Statements are required, even if the acquisition exceeds significance at the 50% level. Accordingly, following the Amendments, there is no difference in the required audited annual Historical Financial Statements between an acquisition at the 40% to 50% level, and the greater than 50% level.

The prior rules also required a presentation of the interim period of the current fiscal year and the comparable interim period of the prior year for any significant acquisition requiring Historical Financial Statements. The Amendments provide that where any Significance Test exceeds the 20% level but none exceed the 40% level, financial statements for only the “most recent” interim period are required. The revision eliminates the need to provide comparable prior-year interim period Historical Financial Statements when only one year of audited annual Historical Financial Statements is required.

Thus, the required periods of Historical Financial Statements are as follows:

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<th>Acquired Business Financial Statements Required</th>
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<td><strong>Significance Threshold</strong></td>
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**40% to 50%**

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<th>Two years of audited annual Historical Financial Statements</th>
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<td>• Two years of audited annual Historical Financial Statements</td>
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<td>• Unaudited historical financial statements for the most recent interim period and the corresponding prior-year interim period</td>
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**Greater than 50%**

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<th>Three years of audited annual historical financial statements</th>
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**Preparation of Pro Formas**
When an acquisition is deemed significant under any of the Significance Tests, Pro Formas — typically, the most recent balance sheet and the most recent annual and interim period income statements — showing the impact of the transaction must also be filed. Under the prior rules, balance sheet adjustments are permitted only if they are directly attributable to the transaction and are factually supportable, and income statement adjustments are permitted only if they are expected to have a continuing impact on the registrant. In order to better depict the potential impact of an acquisition, the Amendments specify that adjustments to Pro Formas are limited to “Transaction Accounting Adjustments” (required), “Autonomous Early Adjustments” (required), and “Management’s Adjustments” (optional). Transaction Accounting Adjustments will reflect only the changes resulting from the application of required accounting to the transaction. Autonomous Early Adjustments will reflect the operations and financial position of the registrant as an autonomous entity when the registrant was previously part of another entity. Finally, the Management’s Adjustments will provide the option to show more forward-looking adjustments, such as synergies and dis-synergies of the transaction to which pro forma effect is being given.

Other Notable Changes

• **Use of Pro Forma Information in Measuring Significance.** The Amendments expand circumstances in which a registrant may use pro forma financial information for significance testing.

• **Conforming Significance of Acquisitions and Dispositions.** Previously, registrants were required to provide Pro Formas for dispositions of businesses at the 10% significance level. The Amendments adjust the significance threshold for the disposition of a business from 10% to 20% to align with the threshold at which an acquired business is deemed significant under the SEC’s rules.

• **Omission of Financially Integrated Acquisitions.** The Amendments allow the omission of pre-acquisition financial statements for acquired businesses that exceed a 20% significance level but do not exceed a 40% significance level once they are included in the registrant’s post-acquisition financial statements for nine months. For acquired businesses that exceed a 40% significance level, financial statements may be omitted once they have been included in the registrant’s financial statements for a complete fiscal year. This will address an issue often faced by registrants filing registration statements and proxy statements: the registrant may be required to update Historical Financial Statements and Pro Formas already filed — even if the acquired entity has been reflected in or integrated into the registrant’s financial statements for a period of time following the acquisition. Now, if financial results of the acquisition have been integrated for the period of time set forth above, no updating will be required.

• **Individually Insignificant Acquisitions.** The requirement under Rule 3-05 of Regulation S-X to file financial statements of individually insignificant businesses under certain circumstances is applicable only to registration statements and proxy statements. Under the existing rules, audited pre-
acquisition Historical Financial Statements are generally not required if an acquired or to be acquired business does not exceed 20% significance, or if the acquisition does not exceed 50% significance and either the acquisition has not yet occurred or the date of the final prospectus or prospectus supplement relating to an offering as filed with the SEC is no more than 74 days after consummation and the Historical Financial Statements have not been previously filed. However, if a series of individually insignificant acquisitions since the date of the registrant’s last balance sheet exceed 50% significance in the aggregate, the registrant must include audited Historical Financial Statements and related Pro Formas for at least the substantial majority of these acquisitions in any registration statement or proxy statement. As a result, the SEC has noted that registrants often provide separate, audited Historical Financial Statements for acquired businesses that are individually not material to the registrant, as well as Pro Formas that do not fully depict the aggregate effect of the insignificant acquisitions. Similar to existing requirements, the Amendments still require financial statements if the aggregate impact of the acquisitions or anticipated acquisitions since the date of the most recent audited balance sheet filed for the registrant — for which Historical Financial Statements are not required either because they do not exceed 20% significance or because of the 74-day grace period — exceeds 50% significance. However, the Amendments require pre-acquisition Historical Financial Statements only for any acquisition that in and of itself exceeds the 20% threshold. Additionally, Pro Formas depicting the aggregate effects of all such businesses are required.

**Registrants Engaged in Oil- and Gas-Producing Activities.** For the acquisition of a business that includes “significant oil- and gas-producing activities,” the Amendments codify the SEC’s practice of allowing registrants to provide abbreviated financial statements. The financial statements may consist of income statements modified to exclude expenses not comparable to the proposed future operations, such as depreciation, depletion and amortization, corporate overhead expense, income taxes, and interest expense, provided that certain conditions are met.

**Smaller Reporting Companies.** The Amendments make corresponding changes to the smaller reporting company requirements in Article 8 of Regulation S-X, which will also apply to registrants relying on Regulation A. The Amendments revised Rule 8-05 to require that the preparation, presentation, and disclosure of Pro Formas by smaller reporting companies substantially complies with Article 11. The Amendments also revised Rule 8-04 to direct registrants to Rule 3-05 for the requirements relating to the Historical Financial Statements of businesses acquired or to be acquired, other than for form and content requirements for such financial statements, which should continue to be prepared in accordance with Rules 8-02 and 8-03.

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