SEC Adopts Amendments to Financial Disclosures Relating to Acquired and Disposed Businesses

On May 21, 2020, the Securities and Exchange Commission (the "SEC") adopted amendments to certain requirements in Regulation S-X related to financial information for acquisitions and dispositions of businesses, including real estate operations.[1] The SEC also adopted new financial disclosure requirements, including Rule 6-11 of Regulation S-X, for acquisitions involving investment companies registered under the Investment Company Act and business development companies (collectively, "investment companies"). The SEC adopted the amendments largely as proposed on May 3, 2019,[2] with some modifications to address comments received from market participants.

The amendments will be effective on January 1, 2021. However, voluntary compliance with the final amendments is permitted in advance of the effective date.

I. Amendments to the Definition of "Significant Subsidiary"

The amendments revise the investment test (the "Investment Test") and the income test (the "Income Test") set forth in the definition of "significant subsidiary" in Rule 1-02(w) of Regulation S-X. This term is used throughout Regulation S-X, Regulation S-K, and certain other SEC rules and forms, including in determining whether financial statements of a business that has been acquired or is to be acquired are required to be filed.

A. Investment Test

The Investment Test has been amended to compare the registrant's investments in and advances to the acquired business to the aggregate worldwide market value of the registrant's voting and non-voting common equity ("aggregate worldwide market value"). In response to concerns regarding market volatility, the final amendments require registrants to use the average of the 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 use of aggregate worldwide market value is expressly limited to acquisitions and dispositions. The current Investment Test, which focuses on the carrying value of the registrant's total assets rather than aggregate worldwide market value, will still apply if the registrant does not have publicly traded common equity or for any other purposes for which the Rule 1-02(w) definition is applicable.

As discussed in the Adopting Release, the final amendments also revise the Investment Test to clarify when contingent consideration must be included as "investments in" the acquired or disposed business.

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[1] For the full text of the release, see SEC, Amendments to Financial Disclosures about Acquired and Disposed Businesses, SEC Release No. 33-10786 (May 21, 2020), available here (the "Adopting Release"). Unless otherwise specified, quoted statements in this memorandum are taken from the Adopting Release.

[2] Amendments to Financial Disclosures about Acquired and Disposed Businesses, Release No. 33-10635 (May 3, 2019) [84 FR 24600 (May 28, 2019)] (the "Proposing Release"), available here. We discussed the Proposing Release in our Firm Memorandum – SEC Proposes Amendments to Financial Disclosures Relating to Acquired and Disposed Businesses (May 23, 2019), available here.

B. Income Test

The Income Test currently focuses on one component—net income—and compares a registrant's equity in the income or loss from continuing operations of the acquired business before income taxes, exclusive of amounts attributable to any non-controlling interest, to the same measure of the registrant. The final amendments add a revenue component that compares a registrant's proportionate share of the total revenue from continuing operations (after intercompany eliminations) of the acquired business to the total revenue (after intercompany eliminations) of the registrant in its most recent fiscal year. Under the final amendments, Rule 3-05 Financial Statements (as defined below) will be required under the Income Test only if the acquired business meets both the net income component and the revenue component. However, the revenue component will not apply if either the registrant and its consolidated subsidiaries or the acquired subsidiary did not have material revenue in each of the two most recently completed fiscal years. If both components are met, the registrant may use the lower of the two components to determine the number of periods for which Rule 3-05 Financial Statements are required.

The Proposing Release had included an amendment to calculate the net income component using income or loss from continuing operations after income taxes, rather than before income taxes. However, the Adopting Release did not include this amendment in light of comments received, including concerns that after-tax amounts could distort the significance determination due to factors such as the entity's tax status and the volatility of income taxes.

II. Amendments to Historical Financial Statement Requirements for Acquired Businesses

Rule 3-05 of Regulation S-X generally requires registrants to provide separate audited annual and unaudited interim pre-acquisition financial statements of any significant business, other than a real estate operation, acquired or to be acquired ("Rule 3-05 Financial Statements"). The reporting requirements, including the number of years of financial information that must be provided, depend on the relative significance of the acquisition as determined by Rule 1-02(w).

A. Reporting Periods for Rule 3-05 Financial Statements

As set forth in the table below, under the current rules, Rule 3-05 Financial Statements are required for up to three years, depending on the relative significance of the acquisition, or such shorter period as the business has been in existence. The amendments to Rule 3-05 eliminate the requirement to file the third year of audited financial statements, so that in no event will more than two years of Rule 3-05 Financial Statements be required.[3] The final amendments also revise Rule 3-05 for acquisitions where a significance test exceeds 20%, but none exceeds 40%, to require financial statements only for the "most recent" interim period specified in Rules 3-01 and 3-02 rather than "any" interim period. As a result, registrants will no longer bear the additional burden of preparing a comparative interim period when only one year of audited financial statements is required.

[3] In adopting these changes, the SEC noted that if trends depicted in Rule 3-05 Financial Statements are not indicative or are otherwise incomplete, Rule 4-01(a) requires that a registrant provide "such further material information as is necessary to make the required statements, in light of the circumstances under which they are made, not misleading." 17 CFR 210.4-01(a).

The table below summarizes the current and amended rules for reporting periods to be filed.

Relative Significance	Current Reporting Requirements	Amended Reporting Requirements
None of the significance tests exceeds 20%	No financial statements required	No financial statements required
At least one of the significance tests exceeds 20%, but none exceeds 40%	One year of audited financial statements, and unaudited financial statements for any interim periods specified in Rules 3-01 and 3-02	One year of audited financial statements, and unaudited financial statements only for the most recent interim period specified in Rules 3-01 and 3-02
At least one of the significance tests exceeds 40%, but none exceeds 50%	Two years of audited financial statements, and unaudited financial statements for any interim periods specified in Rules 3-01 and 3-02	Two years of audited financial statements, and unaudited financial statements for any interim periods specified in Rules 3-01 and 3-02
At least one of the significance tests exceeds 50%	Three years of audited financial statements, and unaudited financial statements for any interim periods specified in Rules 3-01 and 3-02	

B. Omission of Rule 3-05 Financial Statements for Businesses Included in the Registrant's Financial Statements

Under the current rules, Rule 3-05 Financial Statements may be omitted once the operating results of an acquired business have been reflected in the registrant's audited consolidated financial statements for a full fiscal year, unless (i) Rule 3-05 Financial Statements have not been previously filed or (ii) the acquired business is of "major significance" to the registrant. The final amendments eliminate these two exceptions. In response to comments received, the Adopting Release also modifies the length of reporting periods under Rule 3-05 to provide consistency with other rules. The final amendments allow omission of pre-acquisition financial statements for businesses with at least 20%, but not more than 40%, significance once they are included in the registrant's post-acquisition results for nine months (rather than the proposed full fiscal year). For businesses that exceed 40% significance, the final amendments allow omission of pre-acquisition financial statements once they are included in the registrant's post-acquisition financial statements for a full fiscal year.

C. Individually Insignificant Acquisitions

Although Rule 3-05 Financial Statements are not generally required under the current rules if an acquired business does not exceed 20% under any significance test, a registrant is currently required to submit audited historical pre-acquisition financial statements if the aggregate impact of the "individually insignificant businesses" acquired since the date of the most recent audited balance sheet filed for the registrant exceeds 50%. These financial statements must cover at least the substantial majority of the businesses acquired, and they must be included in either a proxy statement or a registration statement. Registrants must also provide pro forma financial information pursuant to Article 11.

Under the amended rules, registrants will still be required to provide pro forma financial information showing the aggregate effects of all "individually insignificant businesses" acquired or to be acquired in all material

respects. However, pre-acquisition historical financial statements will only be required for those businesses with individual significance exceeding 20% that are not yet required to file financial statements. The Adopting Release acknowledges concerns regarding whether auditors will be able to provide negative assurance in "comfort letters" to underwriters on the combined pro forma financial information where historical financial statements for individually insignificant acquisitions have not been reviewed or audited. The Adopting Release states that "the 'reasonable investigation' and 'reasonable care' provisions of Sections 11 and 12 of the Securities Act are also fact specific and depend on a variety of factors." This observation appears to acknowledge that underwriters' due diligence obligations, including the level of comfort obtained in comfort letters from auditors, should be informed by the facts and circumstances. The Adopting Release acknowledges that auditors and their clients may need to take additional steps to provide negative assurance in these cases but states that such concerns are outweighed by the need to improve the usefulness of information provided to investors.

D. Acquisitions of Foreign Businesses

The amendments expand the use of, or reconciliation to, International Financial Reporting Standards ("IFRS"), as issued by the International Accounting Standards Board ("IASB"), in certain circumstances. Rule 3-05(c), as amended, permits foreign private issuers that prepare their financial statements using IFRS-IASB to reconcile Rule 3-05 Financial Statements that were not prepared using U.S. generally accepted accounting principles ("U.S. GAAP") to IRFS-IASB rather than U.S. GAAP. The final amendments also permit Rule 3-05 Financial Statements to be prepared in accordance with IFRS-IASB without reconciliation to U.S. GAAP if the acquired business would qualify to use IFRS-IASB if it were a registrant. In response to comments on the proposed amendments, the Adopting Release reflects certain modifications, such as allowing an acquired business that would qualify as a foreign private issuer if it were a registrant to reconcile to IFRS-IASB rather than U.S. GAAP when the registrant is a foreign private issuer that uses IFRS-IASB.

E. Abbreviated Financial Statements for Carveout Acquisitions

As amended, Rule 3-05(e) allows registrants to provide audited annual and unaudited interim abbreviated financial statements of assets acquired and liabilities assumed, and statements of revenues and expenses (exclusive of corporate overhead, interest and income tax expenses), when acquiring a component of an entity, such as a product line, that is defined as a "business" under Rule 11-01(d). Under the amended rules, these abbreviated financial statements must contain certain additional disclosures related to the omitted expenses. The Adopting Release also includes the proposed amendment to Rule 3-05(f), codifying the SEC Staff's current practice of allowing abbreviated financial statements for an acquired business that includes "significant oil and gas producing activities."

III. Amendments to Pro Forma Financial Statement Requirements for Significant Acquisitions and Dispositions

Article 11 of Regulation S-X currently requires registrants to file unaudited pro forma financial information for acquired or disposed businesses, which typically includes the most recent balance sheet and most recent annual and interim period income statements. In general, pro forma financial information combines the historical financial statements of the registrant and the acquired business and contains certain adjustments showing the impact of the acquisition or disposition.

A. Use of Pro Forma Financial Information to Measure Significance

In making significance determinations, a registrant is currently permitted to use pro forma, rather than historical, financial information if it has made a significant acquisition subsequent to the latest fiscal year-end and

has filed its Rule 3-05 Financial Statements and pro forma financial information on Form 8-K for the acquisition. However, the current rule does not apply to pro forma financial information reflecting significant dispositions or to registrants filing initial registration statements. The final amendments expand the use of pro forma financial information for all filings that may require Rule 3-05 Financial Statements or Rule 3-14 Financial Statements. As amended, Rule 11-01(b)(3) now permits registrants to test significance using filed pro forma financial information that includes only significant business acquisitions and dispositions consummated after the latest fiscal year-end for which the registrant's financial statements are required if registrants have filed (i) the Rule 3-05 Financial Statements or Rule 3-14 Financial Statements for such acquired business and (ii) the pro forma financial information for any such acquired or disposed business as required by Article 11. The final amendments also clarify that once a registrant uses pro forma financial information to measure significance, it must continue to do so until its next annual report on Form 10-K or Form 20-F is filed.

B. Revised Pro Forma Adjustment Criteria

The final amendments replace the existing pro forma adjustment criteria under Article 11 with simplified requirements to depict the accounting for the transaction and provide the option to depict synergies and dis-synergies of the acquisitions and dispositions for which pro forma effect is being given. The revised pro forma adjustment criteria are separated into three categories:

- "Transaction Accounting Adjustments" reflecting only the application of required accounting for the acquisition, disposition or other transaction under U.S. GAAP or IFRS-IASB, regardless of whether the impact is expected to be recurring or nonrecurring;

- "Autonomous Entity Adjustments" reflecting the operations and financial position of the registrant as an autonomous entity when the registrant was previously part of another entity; and

- "Management's Adjustments" depicting the synergies and dis-synergies of acquisitions and dispositions for which the pro forma effect is being given.

Transaction Accounting Adjustments and Autonomous Entity Adjustments are mandatory adjustments. Under the Proposing Release, registrants would have been required to disclose Management's Adjustments in the pro forma financial information. However, as a result of comments received from market participants, including comments that not all transactions attach the same level of importance to synergies as a rationale for pursuing the transaction and that there may be different levels of confidence on different types of synergies and transaction effects, the Adopting Release makes Management's Adjustments optional. The Adopting Release encourages registrants to include them if the registrant's management believes such adjustments would enhance an understanding of the pro forma effects of the transaction and the conditions to inclusion are satisfied. Any forward-looking information will be expressly covered by the safe harbors under Rule 175 under the Securities Act and Rule 3b-6 under the Securities Exchange Act.

The final amendments contain the following conditions for presenting Management's Adjustments:

- there is a reasonable basis for each adjustment;

- the adjustments are limited to the effect of such synergies and dis-synergies on the historical financial statements on which the pro forma statement of comprehensive income is based as if they existed as of the beginning of the fiscal year presented, with any expense reductions limited to the amount of the relevant expense incurred in the pro forma period;

- the pro forma financial information reflects all such adjustments that, in management's opinion, are necessary to fairly state the pro forma financial information presented, and disclosure is made to that effect; and

- when synergies are presented, any related dis-synergies must also be presented.[4]

The final amendments also contain certain conditions regarding the presentation of Management's Adjustments. Any Management's Adjustments must be presented in the explanatory notes to the pro forma financial information as reconciliations of pro forma 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 such adjustments. The explanatory notes to the pro forma financial information must also disclose (1) the basis for and material limitations of each such adjustment, including any material assumptions or uncertainties, (2) a description of how the adjustment was calculated, if material, and (3) the estimated time frame for realizing the synergies and dis-synergies.

Any Management's Adjustments included or incorporated by reference into a registration statement, Form 8-K or other filing must be as of the most recent practicable date prior to the effective date, filing date, or other relevant date, as applicable, which may require that the adjustments be updated if incorporated by reference from a previously filed Form 8-K. If any Management's Adjustments will change the number of shares or potential common shares, the change must be reflected within such adjustments in accordance with U.S. GAAP or IFRS-IASB, as applicable, as if any such shares were outstanding as of the beginning of the period.

C. Significance and Business Dispositions

Current Rule 11-01 requires registrants to provide certain pro forma financial information upon the disposition or probable disposition of a significant portion of a business if such disposition is not otherwise fully reflected in the registrant's financial statements. The final amendments raise the significance threshold for business dispositions from 10% to 20% to mirror the threshold for acquired businesses and conform, to the extent applicable, the significance tests used for disposed businesses and real estate operations to the tests used for acquired businesses

IV. Other Amendments

A. Smaller Reporting Companies

The final amendments make corresponding changes to the smaller reporting company requirements in Article 8 of Regulation S-X, which will also apply to issuers relying on Regulation A. Consistent with the proposed amendments, Rule 8-04, as amended, references Rule 3-05 for the requirements relating to the financial statements of an acquired or to be acquired business, except for the form and content requirements contained in Rules 8-02 and 8-03.

B. Real Estate Operations

Current Rule 3-14 of Regulation S-X addresses the unique nature of real estate operations and requires registrants to file financial statements, similar to Rule 3-05 Financial Statements, with respect to significant "real estate operations" that are acquired or to be acquired ("Rule 3-14 Financial Statements"). Consistent with the

[4] The amended rule does not define synergies or dis-synergies. However, the Proposing Release referenced "closing facilities, discontinuing product lines, terminating employees, and executing new or modifying existing agreements, that are both reasonably estimable and have occurred or are reasonably expected to occur" as examples, and the Adopting Release mentions synergies "through economies of scale or economies of scope."

Proposing Release, the amended Rule 3-14 defines "real estate operations" as "a business that generates substantially all of its revenues through the leasing of real property." The final amendments align Rule 3-14 with Rule 3-05 to the extent no unique industry considerations exist and clarify the application of 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.

C. Investment Companies

Investment company registrants currently apply the general provisions in Articles 1, 2, 3 and 4 of Regulation S-X for financial reporting purposes, unless subject to the special rules in Article 6 of Regulation S-X. Article 6 does not currently contain any specific rules or reporting requirements for investment companies that acquire other investment companies and other types of funds (collectively, "acquired funds"), so investment companies currently apply the general requirements of Rule 3-05 and the pro forma financial information requirements in Article 11.

The amendments add a new prong to the definition of "significant subsidiary" in Rule 1-02(w) that is specifically tailored to investment companies. The Adopting Release also includes new Rule 6-11 and amends Form N-14 to address financial reporting for fund acquisitions by investment companies and business development companies. Please refer to the Adopting Release and the related rules for additional details.

V. Conclusion

With the adoption of the final amendments to financial disclosure requirements relating to acquired and disposed businesses, the SEC intends to improve the quality of information provided to investors, facilitate more timely access to capital, and reduce complexity and costs associated with preparing financial disclosures.

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned in it, please do not hesitate to call or email authors Geoffrey E. Liebmann at 212.701.3313 or gliebmann@cahill.com; Susanna M. Suh at 212.701.3686 or ssuh@cahill.com; or Sara E. Johnson at 212.701.3156 or sejohnson@cahill.com; or publications@cahill.com.