

## **SEC Proposes Amendments to Financial Disclosures Relating to Acquired and Disposed Businesses**

On May 3, 2019, the Securities and Exchange Commission (the “SEC”) issued a release proposing amendments to the requirements in Rule 3-05, Rule 3-14 and Article 11 of Regulation S-X and related rules and forms for financial statements relating to acquisitions and dispositions of businesses.<sup>1</sup> The SEC also proposed new financial disclosure rules, including proposed 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”). These proposals are the product of the SEC’s ongoing evaluation of disclosure requirements, including feedback received in response to the *Request for Comment on the Effectiveness of Financial Disclosures About Entities Other Than the Registrant* issued in 2015.<sup>2</sup> The proposed amendments are intended to improve financial information provided to investors, facilitate timely access to capital, and reduce complexity and costs associated with preparing financial disclosures.

### **I. Amendments to Rule 3-05 and Other Related Rules**

Rule 3-05 of Regulation S-X generally requires registrants to provide separate audited annual and unaudited interim pre-acquisition financial statements of any business,<sup>3</sup> 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 to the registrant, which is measured using investment, asset and income tests provided in the “significant subsidiary” definition in Rule 1-02(w).

#### **A. Significance Tests**

In order to improve the application of the significance tests, provide more meaningful significance determinations and reduce costs to registrants, the SEC has proposed substantive revisions to the investment test and income test provided in Rule 1-02(w).<sup>4</sup>

The investment test currently compares the registrant’s investment in and advances to the acquired business to the carrying value of the registrant’s total assets reflected in its most recent annual financial statements required to be filed at or prior to the acquisition date. Under the proposed amendment, the registrant’s investment in and advances to the acquired business would be compared to the aggregate worldwide market value of the registrant’s voting and non-voting common equity (“aggregate worldwide market value”) as of the last business day of the

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<sup>1</sup> SEC press release available at <https://www.sec.gov/rules/proposed/2019/33-10635.pdf>.

<sup>2</sup> Release No. 33-9929 (Sept. 25, 2015) [80 Fed. Reg. 59083 (Oct. 1, 2015)].

<sup>3</sup> A “business” may be a component of an entity, such as a product line, that does not constitute a separate entity, subsidiary or division. See Rule 11-01(d) of Regulation S-X for the definition of a “business.”

<sup>4</sup> The SEC has not proposed substantive revisions to the asset test, but there are a number of non-substantive proposed amendments that apply to all three significance tests. The proposed revisions would apply to Rule 3-05 and other rules and forms that require disclosure related to significant subsidiaries or otherwise rely on the significance tests in Rule 1-02(w) to determine disclosure.

registrant’s most recently completed fiscal year.<sup>5</sup> The current test, however, would still apply if the registrant did not have publicly traded common equity.

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 noncontrolling interest, to the same measure of the registrant. The proposed amendment simplifies the calculations required for the net income component by using income or loss from continuing operations *after* income taxes, rather than *before* income taxes. It also clarifies that, when either the registrant or the acquired business (but not both) has a net loss, net income should be calculated using the absolute value of equity. The SEC has also proposed adding a revenue component to the income test when the registrant and the acquired business have recurring annual revenue. Under the proposed amendment, the acquired business must satisfy the net income component and revenue component before Rule 3-05 Financial Statements would be required under the income test. If both components are met, the registrant would use the lower of the two components to determine the number of periods for which Rule 3-05 Financial Statements are required.

## **B. Reporting Periods for Rule 3-05 Financial Statements**

Under the current rules, Rule 3-05 Financial Statements are required for the number of years set forth in the table below depending on the relative significance of the acquisition or such shorter period as the business has been in existence. The proposed amendments eliminate the requirement to file the third year of audited financial statements when a significance test exceeds 50% and therefore only require up to two years of Rule 3-05 Financial Statements. The proposed 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 would not bear the additional burden of preparing a comparative interim period when only one year of audited financial statements is required.

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

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<sup>5</sup> For a proposed combination between entities under common control, the investment test would be met when either the net book value of the acquired or disposed business exceeds 10% of the registrants’ and its subsidiaries’ consolidated total assets or the number of common shares exchanged or to be exchanged by the registrant exceeds 10% of its total common shares outstanding at the date the combination is initiated. *See* proposed Rule 1-02(w)(1)(i)(B). Under the proposed Rule 1-02(w)(1)(i)(C), the “investment in” the acquired business includes the fair value of contingent consideration required to be recognized at fair value by the registrant at the acquisition date or, if recognition at fair value is not required, all contingent consideration, except sales-based milestones and royalties, unless the likelihood of payment is remote. Contingent consideration would also be included in the “investment in” the disposed business. *See* proposed Rule 1-02(w)(1)(i)(D).

Relative Significance	Current Reporting Requirement	Proposed Amended Requirement
None of the significance tests exceed 20%	No financial statements required	No change to current requirement
At least one of the significance tests exceeds 20%, but none exceed 40%	Audited financial statements for the most recent fiscal year, and unaudited financial statements for any interim periods specified in Rules 3-01 and 3-02	Only change to current requirement would be 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 exceed 50%	Audited financial statements for the two most recent fiscal years, and unaudited financial statements for any interim periods specified in Rules 3-01 and 3-02	No change to current requirement, but would eliminate the 50% cap and apply when at least one of the significance tests exceeds 40%
At least one of the significance tests exceeds 50%	Audited financial statements for the three most recent fiscal years, and unaudited financial statements for any interim periods specified in Rules 3-01 and 3-02	No additional reporting period required based on a significance test in excess of 50%

### C. Proposed Omission of Rule 3-05 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 such significance to the registrant that omission of such financial statements would materially impair an investor’s ability to understand the historical financial results of the registrant.”<sup>6</sup> The proposed amendments eliminate these two exceptions and no longer require the inclusion of Rule 3-05 Financial Statements once the financial information of the acquired business is included in the registrant’s financial statements for a complete fiscal year. The SEC believes that these proposed amendments would reduce the burden on registrants of preparing unnecessary disclosures while still providing sufficient information to investors.

### D. Individually Insignificant Acquisitions

Although Rule 3-05 Financial Statements are not generally required 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

<sup>6</sup> 17 CFR 210.3-05(b)(4)(iii).

the most recent audited balance sheet filed for the registrant exceeds 50%.”<sup>7</sup> 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 proposed amendments, registrants would be required to provide pro forma financial information showing the aggregate effects of all businesses acquired or to be acquired. However, pre-acquisition historical financial statements would only be required for those businesses with individual significance exceeding 20% that are not yet required to file financial statements.

## **E. Acquisitions of Foreign Businesses**

The SEC has proposed amendments that would expand the use of, or reconciliation to, International Financial Reporting Standards (“IFRS”), as issued by the International Accounting Standards Board (“IASB”), in financial statements of foreign acquired businesses. Under the proposed amendments, domestic and foreign registrants would be permitted to prepare Rule 3-05 Financial Statements in accordance with IFRS-IASB without reconciliation to U.S. generally accepted accounting principles (“GAAP”) if the acquired business would qualify to use IFRS-IASB if it were a registrant. In addition, foreign private issuers that prepare their financial statements using IFRS-IASB would be allowed to reconcile Rule 3-05 Financial Statements prepared using non-U.S. GAAP to IFRS-IASB rather than U.S. GAAP.

## **F. Other Proposed Rules**

Proposed Rule 3-05(e) would allow a registrant to provide abbreviated audited 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 proposed rule, these abbreviated financial statements must contain certain additional disclosures related to the omitted expenses.

Proposed Rule 3-05(f) would codify the SEC staff’s current practice of allowing abbreviated financial statements for an acquired business that includes “significant oil and gas producing activities.”

Proposed revisions to Rule 8-04 would direct smaller reporting companies and Regulation A issuers to Rule 3-05 for the requirements relating to the financial statements of an acquired or to be acquired business while allowing them to rely on the form and content requirements in Rules 8-02 and 8-03.

## **II. Amendments to Article 11 and Related Rules**

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.

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<sup>7</sup> 17 CFR 210.3-05(b)(2)(i).

## **A. Use of Pro Forma Financial Information to Measure Significance**

In making significance determinations, a registrant is currently permitted to use pro forma financial information if it has made a significant acquisition subsequent to the latest fiscal year-end and filed its Rule 3-05 Financial Statements and pro forma financial information on Form 8-K.<sup>8</sup> The current rule does not, however, apply to pro forma financial information reflecting significant dispositions or registrants filing initial registration statements. The SEC has proposed amendments to Rule 11-01(b)(3) to allow registrants to test significance using pro forma financial information that only includes significant business acquisitions and dispositions consummated after the latest fiscal year-end for which the registrant's financial statements are required. For all filings that require Rule 3-05 Financial Statements or Rule 3-14 Financial Statements (as defined below), registrants would be permitted to measure significance using such filed pro forma financial information if the registrant has filed (i) the Rule 3-05 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.

## **B. Pro Forma Adjustment Criteria and Presentation Requirements**

The SEC has proposed replacing the existing pro forma adjustment criteria under Article 11 with two new categories: "Transaction Accounting Adjustments" and "Management's Adjustments." Transaction Accounting Adjustments would reflect only the application of required accounting for the acquisition, disposition or other transaction under U.S. GAAP or IFRS-IASB. Management's Adjustments, on the other hand, would include forward-looking information that depicts the synergies and other unlisted effects of the transaction that are reasonably estimable and have occurred or are reasonably expected to occur.

The proposed amendments also include presentation requirements for Management's Adjustments. More specifically, Management's Adjustments would be presented in a separate column in the pro forma financial information after the presentation of the combined historical statements and Transaction Accounting Adjustments. This presentation would allow investors to distinguish the accounting effects of the underlying acquired business from operational effects of management's plans that are subject to management's discretion and other uncertainties. The SEC's proposal also requires additional disclosures for each Management's Adjustment, including: the material uncertainties and assumptions underlying potential synergies; qualitative information necessary to give a balanced view of the pro forma financial information; and the products, services, and processes involved.

## **C. Significance and Business Dispositions**

The SEC has proposed raising the significance threshold for dispositions of a business from 10% to 20% to conform to the significance threshold for acquired businesses under Rule 3-05. The proposed amendments would also conform the significance tests used for disposed businesses to the tests used for acquired businesses under Rule 3-05. The proposed revisions and all three significance tests would also apply to the dispositions of real estate operations under Rule 3-14. By creating more uniform rules for acquisitions and dispositions, the proposed amendments would simplify compliance for registrants.

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<sup>8</sup> See Rule 3-05(b)(3). The proposed amendments replace the language in Rule 3-05(b)(3) with a reference to Rule 11-01(b)(3).

### III. Amendments to Rule 3-14

Rule 3-14 of Regulation S-X currently requires registrants to file separate audited annual and unaudited interim abbreviated income statements for significant “real estate operations” that are acquired or to be acquired (“Rule 3-14 Financial Statements”).<sup>9</sup> Rule 3-14 does not specifically refer to the “significant subsidiary” definition in Rule 1-02(w) for significance determinations, and there are currently no Securities Act or Securities Exchange Act rules that define “real estate operations” or the “properties” referenced in Rule 3-14. As a result, the SEC has proposed amendments specifying that a modified version of the investment test should be used to determine significance and defining a real estate operation as “a business (as set forth in § 210.11-01(d)) that generates substantially all of its revenues through the leasing of real property.”<sup>10</sup> Other proposed amendments include aligning Rule 3-14 with the new proposals for Rule 3-05 to the extent no unique industry considerations exist.

### IV. Proposed Rule 6-11 and Other Related Amendments

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 SEC has proposed amendments to tailor the financial reporting requirements for investment companies, which include:

- adding a new Rule 1-02(w)(2) with a separate “significant subsidiary” definition for investment companies in Regulation S-X based on modified versions of investment and income tests in Rule 8b-2 under the Investment Company Act;
- creating a new Rule 6-11 to address financial reporting with respect to acquired funds; and
- replacing the current pro forma financial information requirement with a new rule that would require investment companies to provide supplemental financial statements.

### V. Conclusion

The proposed amendments to financial disclosure requirements relating to acquired and disposed businesses demonstrate the willingness of the SEC to streamline the financial disclosure process for registrants and facilitate timely access to capital while continuing to ensure that investors receive sufficient information. The proposal will be subject to a 60-day public comment period, which commences after the publication’s release in the Federal Register.

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<sup>9</sup> Registrants are generally required to file only one year of Rule 3-14 Financial Statements. *See* Rule 3-14(a)(1).

<sup>10</sup> *See* proposed Rule 3-14(a)(2).

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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 Helene Banks at 212.701.3439 or [hbanks@cahill.com](mailto:hbanks@cahill.com); Bradley J. Bondi at 202.862.8910 or [bbondi@cahill.com](mailto:bbondi@cahill.com); Charles A. Gilman at 212.701.3403 or [cgilman@cahill.com](mailto:cgilman@cahill.com); Elai Katz at 212.701.3039 or [ekatz@cahill.com](mailto:ekatz@cahill.com); Geoffrey E. Liebmann at 212.701.3313 or [gliebmann@cahill.com](mailto:gliebmann@cahill.com); Ross Sturman at 212.701.3831 or [rsturman@cahill.com](mailto:rsturman@cahill.com); Sara E. Johnson at 212.701.3156 or [sejohnson@cahill.com](mailto:sejohnson@cahill.com); or Benjamin Lash at 212.701.3312 or [blash@cahill.com](mailto:blash@cahill.com).

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