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Insights

SEC STREAMLINES FINANCIAL STATEMENTS REQUIREMENTS IN CONNECTION WITH M&A TRANSACTIONS

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Introduction

On May 21, 2020, the Securities and Exchange Commission (the "SEC") adopted amendments (the "Amendments") to streamline the financial statement disclosures that are required in connection with acquisition and disposition transactions by U.S. public companies. The Amendments will, among other things (i) revise the requirements for financial statements and pro forma financial information for acquired businesses, (ii) revise the tests used to determine significance of acquisitions and dispositions, and (iii) for certain acquisitions of a component of a business, allow financial statements to omit certain expenses. In connection with the adoption of these amendments, SEC Chairman Jay Clayton stated that the amendments are intended to "enhance the quality of information that investors receive while eliminating unnecessary costs and burdens" by assisting registrants making determinations of whether a subsidiary or an acquired or disposed business is "significant" and improving the related financial disclosure requirements. The amendments are effective January 1, 2021, but registrants may voluntarily comply with the rules as amended prior to the effective date. Our Firm's prior blog post regarding this topic can be found here.

Background

Under existing SEC rules, when a registrant acquires a "business" (other than a real estate operation) that is "significant," Rule 3-05 of Regulation S-X generally requires the registrant to provide separate audited and unaudited pre-acquisition financial statements of that business, and Article 11 of Regulation S-X requires the registrant to provide pro forma financial information of the combined business using historical data of the registrant and the acquired business to show what the combined business might have looked if the acquisition had been completed on an earlier date. Certain proxy and registration statements require such information for the substantial majority of individually insignificant consummated and probable transaction since the most recent audited balance sheet date where a significance test of any combination of those transactions exceeds 50%. The number of years of financial information that must be provided depends on the relative significance of the acquisition to the registrant. Rule 3-14 of Regulation S-X sets forth corresponding financial statement and pro forma requirements in connection with the acquisition of "significant" real estate operations.

Rule 1-02(w) of Regulation S-X contains three significance tests: (1) the Investment Test, (2) the Asset Test and (3) the Income Test. The Investment Test compares a registrant's and its other subsidiaries' "investments in and advances to" an acquired business to the total assets of the registrant. The Asset Test compares a registrant's and its subsidiaries' proportionate share of the acquired business's total assets to the total assets of the registrant. The Income Test compares the registrant's and its other subsidiaries' equity in the income from continuing operations of the acquired business before income taxes, exclusive of amounts attributable to any controlling interests, with the same measure in the registrant's financial statements.

Investment Test and Income Test Amendments

The Amendments amend the Investment Test and the Income Test, while leaving the Asset Test substantively unchanged.

As revised, the Investment Test will compare a registrant's and its other subsidiaries' "investments in and advances to" the acquired or disposed business to the registrant's aggregate worldwide market value, rather than its total assets. The reference to worldwide market value rather than total assets is intended to address the current measurement asymmetry between a registrant's investments and advances in a subsidiary, which are typically measured at fair value, and a registrant's total assets, which are measured at book value. The SEC stated in the release that it believed the use of aggregate worldwide market value in the investment test would be more closely aligned with the purchase or sale price used in the numerator of the Investment Test and would therefore provide a "more meaningful measure" of significance. For registrants that do not have an aggregate worldwide market value, the Investment Test will continue to require the registrant to compare its investments in and advances to the acquired or disposed business to its total assets. In an acquisition or disposition, the registrant's and its other subsidiaries' "investments in" the tested subsidiary are generally the consideration transferred or received (i.e., the purchase or sales price) for the net assets acquired or sold. For acquisitions, the consideration transferred by registrant and its other subsidiaries would be adjusted to exclude the registrant's and its subsidiaries' proportionate interest in the carrying value of assets transferred by the registrant and its subsidiaries consolidated to the tested subsidiary that will remain with the combined entity after the acquisition. In addition, the registrant's and its other subsidiaries' "investments in" the tested subsidiary include the fair value of contingent consideration if required to be recognized at fair value by the registrant at the acquisition date under U.S. GAAP or International Financial Reporting Standard ("IFRS"), as applicable; however if recognition at fair value is not required, it must include all contingent consideration, except contingent consideration for which the likelihood of payment is remote. In order to address commenters' concerns regarding market volatility, the SEC adjusted the final rule to require registrants to use the average of 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, rather than the last business day of the registrant’s most recently completed fiscal year, as originally proposed.

The Amendments will supplement the Income Test to include a new revenue component. Due to its reliance on net income exclusively, the current Income Test often causes registrants with either minimal income or a net loss in a referenced fiscal year to find subsidiaries or acquired or disposed businesses to be significant. The SEC noted that new revenue component of the income test is intended to nullify such outcomes by comparing a registrant’s and its other subsidiaries’ proportionate share of the tested business’s consolidated total revenues (after intercompany eliminations) to the consolidated total revenues of the registrant. A referenced business must meet both the net income component, based on absolute values, and the new revenue component in order to meet the revised Income Test. However, pursuant to the Amendments, a registrant may use the lower of the revenue component and the net income component to determine the period for which Rule 3-05 financial statements are required for a business acquisition. If the registrant or acquisition target does not have recurring annual revenues in each of the two most recently completed fiscal years, only the net income component will apply and will be calculated based on the absolute value of the business’s consolidated income or loss from continuing operations. The SEC noted the amendments to the Income Test were intended to reduce the “anomalous results” that may occur in applying the tests without, the SEC believes, sacrificing material information for investors.

In addition to the above-referenced Investment Test and Income Test changes, the Amendments expand the use of pro forma information in measuring the significance of an acquired business. Under existing Rule 3-05, a registrant is generally permitted to use pro forma (rather than historical) financial information to test significance of a business in cases where the registrant made a significant acquisition after the latest fiscal year-end and filed the required financial statements and pro forma financial information on a Form 8-K. As amended, Rule 3-05 will generally permit a registrant to measure the significance of an acquired or disposed of business using filed pro forma financial information that depicts only significant business acquisitions and dispositions consummated after the latest year-end for which the registrant’s financial statements are required to be filed. The SEC intends for this change to increase the flexibility that registrants have to determine the relative significance of an acquired or disposed business without delaying or accelerating the filing of pro forma financial information that might occur if such pro forma financial information was required to determine significance.

Other Key Amendments

In addition to the changes to the Investment Test and Income Tests described above, the final rules will also implement the following changes:

- Revise Rule 3-05 to (i) reduce the maximum period of required historical financial statements of an acquired business, including for an acquisition that exceeds 50% significance, from three years to two years and (ii) require financial statements for the "most recent" interim period specified in Rules 3-01 and 3-02 rather than "any" interim period for acquisitions where a significance test exceeds 20 percent, but none exceeds 40 percent.
  - The SEC noted that, regardless of the number of years presented, 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."

- Permit disclosure of abbreviated financial statements for carveout transactions where the target business did not maintain separate financial statements. To qualify to use abbreviated financial statements, among other things, the acquired component of a seller must have constituted 20% or less of such entity's total assets and total revenues (both after intercompany eliminations) as of and for the most recent fiscal year.

- Permit the use of, or reconciliation to, IFRS as as issued by the International Accounting Standards Board (as opposed to U.S. GAAP) in certain circumstances involving the acquisition of a foreign business.

- No longer require a registrant to file separate acquired business financial statements once the business has been included in the registrant's post-acquisition audited annual financial statements for either nine months (for acquisitions that exceed 20% significance but do not exceed 40% significance) or a complete fiscal year (for acquisitions that exceed 40% significance). Under existing Rule 3-05, an acquired business's financial statements may be omitted by a registrant when the operating results of the acquired business have been reflected in audited consolidated financial statements for a complete fiscal year. Under the existing rule, however, if Rule 3-05 financial statements for the acquired business have not been previously been filed, they must be provided by the registrant even if the acquired business has been included in the post-acquisition audited results of the registrant. The SEC noted that this requirement can delay a registrant's offering and access to capital, while providing information that is often less meaningful to investors, because of both the diminishing utility of pre-acquisition periods after the acquired business is reflected in post-acquisition results, and the fact that post-acquisition results of the combined business are generally not comparable to the pre-acquisition results of the acquired business.

- Modify and enhance the required disclosure for the aggregate effect of individually insignificant acquisitions for which financial statements are not required or are not yet required. Pro forma financial information showing the aggregate effect of all acquisitions that collectively exceed 50% significance are still required, but historical financial statements will only be required for those businesses whose individual significance exceeds 20%. Under the existing rules, if a series of acquisitions exceeds 50% significance, a registrant must file the historical audited financial statements for those businesses constituting the mathematical majority of the group in addition to the pro forma financial statements.

- Amend the pro forma financial information requirements of Article 11 of Regulation S-X by replacing the pro forma adjustment criteria with simplified requirements to present the accounting for the transactions in the following three columns:
  - "Transaction Accounting Adjustments" (adjustments required to account for the transaction under U.S. GAAP or IFRS);
  - "Autonomous Entity Adjustments" (for spinout transactions); and
  - "Management's Adjustments" (an optional column to show synergies and related forward-looking transaction effects).

- Clarify when financial statements and pro forma financial information are required, and update the language used in in the SEC's rules to take into account concepts that have developed since adoption of the rules, including to:
  - specify that financial statements are required if an acquisition has occurred during the most recent fiscal year or subsequent interim period for which a balance sheet is required by Rule 3-01 (Consolidated Balance Sheets), or if a business acquisition has occurred or is probable after the date that the most recent balance sheet has been filed; and
  - provide that a registrant may continue to determine the significance using amounts reported in its annual report on Form 10-K for the most recent fiscal year when the registrant has filed its annual report Form 10-K after the closing date of the applicable acquisition, but before the date the registrant is required to file the target's financial statements on Form 8-K.

- Raise the significance threshold for the disposition of a business from 10% to 20% and to conform, to the extent applicable, the tests used to determine significance of a disposed business to those used to determine significance of an acquired business.

- Make corresponding changes to the smaller reporting company requirements in Article 8 of Regulation S-X.

Conclusion

The Amendments update rules that have not been significantly changed since their initial adoption over 30 years ago. As stated by the SEC, the Amendments are intended to improve the financial information about acquired or disposed businesses that is provided to investors, facilitate more timely access to capital, and reduce the complexity and costs to registrants to prepare the required disclosure. The result is that, as a practical matter (in particular as it relates to the Income Test, but perhaps as well for the other changes), registrants will likely make fewer determinations of significance. While the Amendments streamline and simplify various aspects of the rules dictating the financial statement requirements in connection with significant acquisitions and dispositions, the underlying rules and requirements related thereto remain highly complex, and registrants are advised to take great care in analyzing them in connection with the consummation of corporate transactions.

RELATED CAPABILITIES

- Securities & Corporate Governance

MEET THE TEAM

Robert J. Endicott

St. Louis

rob.endicott@bclplaw.com
+1 314 259 2447

Todd M. Kaye

St. Louis

todd.kaye@bclplaw.com
+1 314 259 2194
