

# SEC PROPOSES AMENDMENTS TO M&A RELATED FINANCIAL DISCLOSURES

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## Capital Markets

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## BACKGROUND

On May 3, 2019, the Securities and Exchange Commission ("SEC") proposed extensive amendments to the rules governing the financial disclosures that reporting companies must make regarding the acquisition and disposition of businesses. The proposed amendments would modify Rules 3-05 and 3-14 and Article 11 of Regulation S-X, as well as related rules and forms. The SEC will open the proposal for public comment for 60 days.

The stated purpose of the proposed amendments is to improve the financial information investors receive regarding acquired or disposed businesses, facilitate more timely access to capital, and reduce the complexity and costs of preparing the disclosure. We believe the amendments advance the SEC's ongoing efforts to simplify and reduce the disclosure requirements of reporting companies without materially detracting from the effectiveness of the financial information required to be provided to investors.

## HIGHLIGHTS OF PROPOSED AMENDMENTS

### *Changes to the Significance Tests*

Rule 3-05 of Regulation S-X specifies when and what financial disclosures must be made with respect to significant businesses acquired or to be acquired by reporting companies. Whether an acquisition is significant is determined by the investment, asset, and income tests set forth in the "significant subsidiary" definition in Rule 1-02(w). The proposed amendments would significantly modify the investment and income tests, but leave the asset test substantively unchanged.

With respect to the investment test, in order to better reflect the economic significance of the acquisition to the reporting company, the proposed amendments would require a comparison of (1) the reporting company's investment in and advances to the target to (2) the aggregate worldwide market value of the reporting company's voting and non-voting common equity, when available. Aggregate worldwide market value would be determined as of the last business day of the reporting company's most recently completed fiscal year. If the reporting company's aggregate worldwide market value is not available, the reporting company would employ the current investment test, which compares (1) its investment in and advances to the target to (2) the carrying value of its total assets.

With respect to the income test, the current test utilizes net income as the single component. To reduce the distortion and anomalous results that can result from non-recurring or infrequent expenses, gains or losses, the proposed amendments add revenue as a new component to the test in cases where both the reporting company

and the target have recurring annual revenue. Additionally, the proposed amendment would modify the net income calculation so that it is based on income or loss from continuing operations after taxes rather than the current calculation that is based on pre-tax income or loss.

The proposed amendments would also expand the use of pro forma financial information in determining the significance of acquired businesses.

### ***Periods to be Presented***

Rule 3-05 currently requires up to three years of target financial statements depending on the relative significance of the acquisition. The proposed amendments would reduce, from three to two, the number of years of target financial statements for an acquisition that exceeds 50% significance.

Where significance levels are between 40% and 50%, amended Rule 3-05 would continue to require two years of audited financial statements and unaudited financial statements for the most recent interim period and the corresponding prior year interim period.

Where significance levels are between 20% and 40%, amended Rule 3-05 would continue to only require one year of audited financial statements, but would eliminate the requirement to provide a comparative interim period statement.

Where significance levels are below 20%, amended Rule 3-05 would continue to allow financial statements to be excluded in their entirety.

### ***Carve-Out Acquisitions***

The proposed amendments would allow a reporting company to exclude corporate overhead, interest, and income tax expenses from the required Rule 3-05 audited financial statements when it acquires a component of an entity, such as a product line or line of business, and certain conditions are met.

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

Currently, a reporting company is required to make significance determinations by comparing the most recent annual financial statements of the target to its own at or prior to the date of the acquisition. A reporting company currently may use pro forma financial information only if the acquisition occurred after the end of the latest fiscal year and the reporting company filed the target's Rule 3-05 financial statements and pro forma financial information on Form 8-K. The proposed amendments would expand the circumstances in which a reporting company can use pro forma financial information for significance determinations.

Additionally, the proposed amendments would allow a reporting company to use pro forma financial information with respect to significant dispositions occurring after the end of the latest fiscal year if certain conditions are met. The proposed amendments would specifically prohibit the use of management adjustments when using pro forma financial information to determine significance.

### ***Individually Insignificant Acquisitions***

Current rules require a reporting company to file historical audited financial statements as well as pro forma financial information if it acquires unrelated businesses that do not individually meet the applicable significance thresholds but exceed 50% significance in the aggregate. In these cases, the reporting company must provide complete pro forma financial information and audited historical financial statements covering at least a substantial

majority of the businesses acquired. Under the proposed amendments, a reporting company would still provide complete pro forma financial information, but it would only be required to provide audited historical financial statements for any business in the group whose individual significance exceeds 20%.

### ***Significance Thresholds for Dispositions***

The proposed amendments would raise the significance threshold to 20% from its current level of 10% with respect to the requirement to disclose pro forma financial information upon the disposition of a business. Additionally, the proposed amendments would modify the business disposition significance tests to conform with the changes to the acquired business significance tests described above.

### ***Smaller Reporting Companies***

The proposed amendments would make corresponding changes to the smaller reporting company requirements in Article 8 of Regulation S-X.

### ***Additional Proposed Modifications***

The proposed amendments would also, among other things:

- Permit, in certain circumstances, the use of, or reconciliation to, International Financial Reporting Standards as issued by the International Accounting Standards Board;
- No longer require separate acquired business financial statements once the business has been included in the reporting company's post-acquisition financial statements for a complete fiscal year;
- Align Rule 3-14 with Rule 3-05 where no unique industry considerations exist;
- 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;
- Amend the pro forma financial information requirements to improve the content and relevance of that information; specifically, these improvements would include disclosure of "Transaction Accounting Adjustments," reflecting the accounting for the transaction, and "Management's Adjustments," reflecting reasonably estimable synergies and transaction effects; and
- Add a definition of significant subsidiary that is tailored for investment companies.

## **KEY CONTACTS**



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