# SEC Provides Welcome Updates to Financial Statement Requirements for Acquisitions and Dispositions

June 1, 2020

On May 21, 2020, the U.S. Securities and Exchange Commission adopted final rules amending disclosure requirements for financial reporting for acquisitions and dispositions of businesses. The final rules will become effective on January 1, 2021, although voluntary early compliance is permitted so long as the rules are applied in their entirety from the date of early compliance. The reforms are intended to improve financial information about acquired and disposed businesses, facilitate more timely access to capital and reduce the complexity and cost to prepare the required disclosures.

The amendments are the result of the SEC's ongoing comprehensive evaluation of disclosure requirements and primarily cover financial disclosure requirements in Rule 3-05 and Article 11 of Regulation S-X relating to registration statements and Exchange Act reports.[1] The final rules that have been adopted are largely consistent with the SEC's May 2019 proposing release, which we discussed here.

**Background**

When a registrant acquires a significant business, Rule 3-05 of Regulation S-X requires disclosure of separate audited annual and unaudited interim pre-acquisition financial statements of that business. The number of years of audited financial statements that must be provided depends on the relative significance of the acquired business to the registrant. In addition, Article 11 of Regulation S-X requires registrants to file unaudited pro forma financial information relating to certain significant acquisitions and dispositions.

Whether a transaction is significant, and therefore what historical financial statements and pro forma financial information are required to be provided in connection with that transaction, is determined by applying three tests set forth in Rule 1-02(w) of Regulation S-X: the investment test, the income test and the asset test.

This alert covers the following amendments:

- updates to the investment test and the income test;

[1] The final rules also made corresponding changes to the smaller reporting company requirements in Article 8 of Regulation S-X, amended portions of Rule 3-14 of Regulation S-X, which addresses real estate operations to be acquired, and introduced new Rule 6-11 of Regulation S-X to govern financial reporting for acquisitions involving investment companies.

- expansion of the use of pro forma financial information in measuring significance;
- changes to required financial statements at various significance levels;
- changes to the significance threshold and tests for a disposed business;
- updates to financial statements required in carve-out transactions;
- when financial statements not previously filed or those relating to an acquisition of major significance may be omitted;
- changes to the treatment of individually insignificant acquisitions;
- revisions to adjustments that may be made to pro forma financial information; and
- codification of historical reporting practices for financial statements of oil and gas producers.

**Amendments to Significance Tests**

The SEC has enacted amendments to the investment and income tests as described below. Apart from certain clarifying changes, the asset test remains substantially unchanged under the amendments.

***Investment Test***

The changes to the investment test include:

| | Former Investment Test | Amended Investment Test |
|---|---|---|
| **Comparison Metric** | A registrant's investment in and advances to the tested business is compared to the ***carrying value of the registrant's total assets (i.e., book value)***. | *Acquisitions or Dispositions*<br><br>For acquisitions and dispositions, a registrant's investment in and advances to the tested business is compared to the ***aggregate worldwide market value of the registrant's voting and non-voting common equity*** (including equity held by affiliates), calculated as 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 (i) the registrant's announcement date or (ii) the agreement date of the acquisition or disposition.<br><br>If the registrant does not have an aggregate worldwide market value, the |

| | Former Investment Test | Amended Investment Test |
|---|---|---|
| | | carrying value of the registrant's total assets will continue to be used.<br><br>*Combinations Between Entities or Businesses Under Common Control*<br><br>For a combination between entities or businesses under common control, the investment test compares:<br><br>(1) the net book value of the acquired business to the registrant's and its subsidiaries' consolidated total assets; and<br><br>(2) the number of common shares exchanged or to be exchanged by the registrant to the total common shares outstanding at the date the combination is initiated.[2]<br><br>*Other*<br><br>In all other cases, the investment test remains unchanged. |
| **Contingent Consideration** | A registrant's "investment in" a tested target includes ***the gross amount of contingent consideration if likelihood of payment is more than remote***.[3] | A registrant's "investment in" a tested target includes ***the fair value of contingent consideration*** required to be recognized at fair value by the registrant at the acquisition date under U.S. GAAP or IFRS-IASB, as applicable.<br><br>If recognition at fair value is not required, the amendment requires the gross amount of contingent consideration to be included, unless the likelihood of payment is remote. |

[2] Under the amended investment test for combinations between entities or businesses under common control, the threshold for significance under either of the comparison metrics is 10%, which is a lower threshold than the income test or asset test for such transactions.

[3] The inclusion of contingent consideration in the former investment test is not currently codified in the language of Rule 1-02(w), but instead is based on SEC guidance.

The SEC stated that using the registrant's aggregate worldwide market value aligns the investment test more closely with the economic significance of the acquisition to the registrant, as measuring against total assets may not fully reflect the registrant's current fair value.

In the proposing release, the SEC had proposed measuring aggregate worldwide market value as of the registrant's most recently completed fiscal year end. In response to concerns expressed by commentators regarding market volatility, the final rule measures aggregate worldwide market value closer to the date of acquisition or disposition by calculating such market value as the average of 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.

***Income Test***

Changes to the income test include:

| | **Former Income Test** | **Amended Income Test** |
|---|---|---|
| **Comparison Metric** | A target's income from continuing operations before taxes is compared to the registrant's income from continuing operations before taxes. | Two tests (including the unamended former income test) must be met in order to exceed the applicable significance threshold, thereby reducing the likelihood that an acquisition or disposition will be significant at a particular level:<br><br>(1) The target's income from continuing operations before taxes compared to the registrant's income from continuing operations before taxes; and<br><br>(2) ***The target's revenue compared to the registrant's revenue.***<br><br>The lower of the two tests is used to determine significance for purposes of determining the number of periods for which Rule 3-05 financial statements are required.<br><br>Where a registrant or target does not have material revenue in each of the two most recently completed fiscal years, only the net income test would apply. |
| **Low Income Year** | If the registrant's income for the most recent fiscal year is at least 10% lower than the average income for the last five fiscal years: | In these circumstances, the SEC has clarified that, instead of using zero for loss years for purposes of computing the five-year average, the registrant ***shall use the absolute value of any loss*** in determining the average. |

| | Former Income Test | Amended Income Test |
|---|---|---|
| | • use the five-year average for purposes of the income test instead of prior year; and<br>• use zero for any loss years for purposes of computing five-year average income.[4] | |

By revising the income test to require that the registrant exceed both revenue and net income components when the registrant and the target have recurring annual revenue, the SEC believes the amended income test will more accurately determine whether a business is significant to the registrant and will reduce the frequency of the anomalous result of immaterial acquisitions being deemed significant.

***Asset Test***

The SEC did not substantively revise the asset test, which compares the registrant's and its other subsidiaries' proportionate share of the total assets (after intercompany eliminations) of the tested subsidiary to the total assets of the registrant and its subsidiaries consolidated as of the end of the most recently completed fiscal year.

***Use of Pro Forma Financial Information for Testing***

Significance is generally determined by comparing the most recent annual consolidated financial statements of the target to those of the registrant filed at or prior to the date of acquisition. However, in certain circumstances related to acquisitions only, registrants are permitted to use pro forma financial information to measure significance. Under the amended rules, the SEC has expanded the use of pro forma financial statements to include dispositions as follows:

| Former Rule | Amended Rule |
|---|---|
| Pro forma financial information can be used if the registrant made a ***significant acquisition*** subsequent to the latest fiscal year and previously filed the required pro forma financial information. | Pro forma financial information can be used if the registrant made a significant ***acquisition or disposition*** subsequent to the latest fiscal year-end and previously filed the required pro forma financial information. |

In response to comments to the proposed rules, the SEC provided in the amended rules that once a registrant uses pro forma financial information to measure significance, it must continue to use pro forma financial information to measure significance until the next Annual Report on Form 10-K or Form 20-F is filed. This clarification is a codification of existing practice.

Note that under the amended rules registrants may not include "Management's Adjustments" or "Autonomous Entity Adjustments" (each as described below) when using pro forma financial information to determine significance. Rather, the pro forma financial information must be limited to the applicable subtotals that combine the historical financial information of the registrant and the target business and "Transaction Accounting Adjustments" (as described below).

[4] The use of zero for loss years is based on SEC guidance and not based on the language of Rule 1-02(w).

### *Other Considerations*

Although the amendments clearly impact registrants engaged in M&A activities, these changes also impact other disclosure related to "significant subsidiaries" or that otherwise rely on the significance tests in Rule 1-02(w) to determine the disclosure requirements, including the determination of a registrant's significant subsidiaries for Exhibit 21 to Form 10-K. In addition, companies should review any representations regarding significant subsidiaries made by the company in both acquisition and financing agreements, including underwriting agreements and credit documents, with the new tests in mind, to ensure that the representations may be given without qualification with respect to any existing or additional subsidiaries covered under the new tests.

### Amendments to Required Financial Statements

The former requirements for acquisition financials, as well as the amended requirements, are summarized below.

| **Significance** | **Former Financial Statement Reporting Requirement** | | **Amended Financial Statement Reporting Requirement** | |
|---|---|---|---|---|
| | ***Audited*** | ***Unaudited*** | ***Audited*** | ***Unaudited*** |
| **At or below 20%** | None | None | None (no change) | None (no change) |
| **Above 20% but below 40%** | One year | Most recent interim period ***and corresponding prior year period*** | One year (no change) | Most recent interim period (***eliminates corresponding prior year period***) |
| **Above 40% but below 50%** | Two years | Most recent interim period and corresponding prior year period | Two years (no change) | No change |
| **Above 50%** | ***Three years*** | Most recent interim period and corresponding prior year period | ***Two years*** | No change |

Most notably, the amended rules reduce the financial statement requirements of an acquired business above the 50% significance level from three years to two. The SEC believes that two years of pre-acquisition financial statements are sufficient to allow investors to understand the possible effects of the acquired business on the registrant. Older financial statements, such as the third year of Rule 3-05 financial statements, are less likely to be indicative of the current financial condition and results of operations of the acquired business. We expect the removal of this requirement will provide significant relief to registrants.

Note that registrants wishing to access the capital markets and needing to reflect an acquisition above 20% but below 40% should consult with their underwriters to determine whether continued inclusion of prior year and interim period financials would be desirable from a marketing point of view and should consult with their auditors to determine whether the elimination of a prior period will have any effect on the comfort letter provided to the underwriters.

Although significance in excess of 50% no longer requires financial statements for three years, the 50% threshold continues to be a trigger for other purposes. For example, a U.S. domestic issuer that has completed a significant acquisition must file target and pro forma financial statements within approximately 74 days of closing. Issuers are not technically required to include such financial statements in registration statements for securities offerings within this 74-day window, but they often do include them for materiality purposes. However, if an acquired business is more than 50% significant under any of the three tests, then the issuer must include the required target and pro forma financial statements in a registration statement even if the acquisition has not yet closed but is probable and regardless of whether the 74-day period prior to the date of the required Form 8-K filing has expired. In addition, after an acquisition with greater than 50% significance has closed, securities cannot be offered under already effective shelf registration statements unless target and pro forma financial statements are included, except for secondary offerings or the issuance of securities under outstanding convertible securities or warrants.

**Other Amendments**

***Conforming Amendments for Dispositions***

The amended rules provide certain conforming changes for dispositions, which previously had different rules relative to acquisitions, including:

- Raising the significance threshold for the disposition of a business from 10% to 20%, which matches the lowest significance threshold for an acquisition; and

- Conforming, to the extent applicable, the tests used to determine significance of a disposed business to those used to determine significance of an acquired business, as described above.

***Carve-Outs Acquisitions: Financial Statements for Assets that Constitute a Business***

Registrants frequently acquire a component of an entity, such as a product line or a line of business that does not constitute a separate entity, subsidiary or division. These businesses may not have separate financial statements or maintain separate and distinct accounts necessary to prepare Rule 3-05 financial statements, and making relevant allocations of the selling entity’s corporate overhead, interest and income tax expenses necessary to provide Rule 3-05 financial statements for the business may be impracticable.

The amendments allow registrants to provide, subject to certain presentation requirements, audited financial statements of assets acquired and liabilities assumed, and statements of revenues and expenses (exclusive of corporate overhead, interest and income tax expenses) if each of the following requirements are met:

- the total assets and total revenues (both after intercompany eliminations) of the acquired or to be acquired business constitute 20% or less of such corresponding amounts of the seller and its subsidiaries consolidated as of and for the most recently completed fiscal year[5];

[5] We note that acquirors of private companies may not readily have access to such information. As a result, the acquiror should be sure to request this information from the seller in order to make the necessary determination.

- the acquired business was not a separate entity, subsidiary, operating segment (as defined in U.S. GAAP or IFRS-IASB, as applicable), or division during the periods for which the acquired business financial statements would be required;

- separate financial statements for the business have not previously been prepared; and

- the seller has not maintained the distinct and separate accounts necessary to present financial statements that include the omitted expenses and it is impracticable to prepare such financial statements.

***Omission of "Not Previously Filed" and Major Significance Financial Statements***

| Former Rule | Amended Rule |
| --- | --- |
| Rule 3-05 financial statements may be omitted once the operating results of the acquired business have been reflected in the financial statements of the registrant for a complete fiscal year, ***unless the financial statements have not been previously filed or the acquisition is of major significance (i.e., 80%) to the registrant.*** | Rule 3-05 financial statements may be omitted once the operating results of the acquired business have been reflected in the financial statements of the registrant for nine months (for businesses that exceed 20% significance but do not exceed 40% significance) or a complete fiscal year (for businesses that exceed 40% significance) ***(eliminates the requirement that Rule 3-05 financial statements be provided when they have not been previously filed or the acquired business is of major significance)***. |

This amendment will be of interest to companies filing IPO registration statements. The "not previously filed" exception previously required registrants to test the significance of acquisitions that occurred during the earliest years for which the registrant was required to provide its historical financial statements and, if significant, to provide pre-acquisition financial statements of the acquired business, regardless of whether the acquired business had been reflected in the registrant's financial statements for a complete fiscal year. This requirement could often delay a registrant's offering while providing information that was often less meaningful to investors.

***Individually Insignificant Acquisitions***

Generally, audited historical financial statements are not required if an acquired business does not exceed 20% significance. However, under the former rules, if the aggregate impact of "individually insignificant businesses" acquired since the date of the most recent audited balance sheet filed for the registrant exceeded 50%, certain audited historical financial statements (and related pro forma information) were required to be filed. The SEC has revised the requirements when the aggregate impact of "individually insignificant businesses" acquired since the date of the most recent audited balance sheet filed for the registrant exceeds 50% as follows:

| Former Rule | Amended Rule |
| --- | --- |
| Registrants must file audited historical financial statements (and related pro forma information) covering at least the ***substantial majority*** of the businesses acquired. | Registrants must provide audited historical financial statements ***only for those businesses whose individual significance exceeds 20%***. |

| Former Rule | Amended Rule |
|---|---|
| | However, ***pro forma financial information depicting the aggregate effects*** of all otherwise insignificant business acquisitions must be provided when the aggregate impact of insignificant businesses acquired exceeds 50% significance. |

The SEC believes the amendments will both improve the information provided to investors and reduce burdens on registrants of providing audited historical financial statements for immaterial acquisitions. Preparing disclosure about insignificant acquisitions and negotiating with sellers to timely provide historical financial statements for them can increase the cost of registration and delay access to capital. In addition, requiring pro forma financial information that shows the aggregate effect of the acquired businesses for which financial statements are either not required or not yet required in all material respects rather than only giving effect to a mathematical majority of such businesses, will make it easier for investors to understand the overall effect of those acquisitions on the registrant.

Notably, the SEC acknowledged concerns expressed by some commenters that accountants may not be able to provide negative assurance to underwriters on combined pro forma financial information where historical financial statements included in the pro forma financial information for individually insignificant acquisitions have not been reviewed or audited. The SEC concluded, however, that registrants and accountants could determine whether additional work was necessary to provide negative assurance on a case-by-case basis, rather than requiring all registrants to provide historical financial information that is of limited utility to investors. It remains to be seen whether underwriters will insist on this additional work (assuming accountants are willing or able to perform it and registrants to pay for it) or will forego negative assurance on the combined pro forma financial information.

***Adjustments Made in Pro Forma Financial Information***

Article 11 of Regulation S-X requires registrants to file unaudited pro forma financial information relating to certain significant acquisitions and dispositions. Such pro forma financial information includes historical financial statements of the registrant and the business and is adjusted for certain items if certain criteria are met. Prior to the amendments, the pro forma income statement could only contain adjustments that were directly attributable to the transaction, expected to have a continuing impact on the registrant and factually supportable. Similarly, the pro forma balance sheet could only reflect adjustments that were directly attributable to the transaction and factually supportable, but such adjustments did not need to be expected to be continuing.

The SEC amended the former pro forma adjustment criteria because they were not clearly defined nor easily applied and, in practice, could yield inconsistent presentations for similar fact patterns. The former adjustments also precluded the inclusion of adjustments for the potential effects of post-acquisition actions expected to be taken by management, which can be important to investors.

Under the amendments, the former rules for adjustments have been replaced and expanded with three categories of adjustments: Transaction Accounting Adjustments (which are the essentially the adjustments permitted under the former rules), Autonomous Entity Adjustments (which are made when the registrant was previously part of another entity) and Management's Adjustments (which are intended to reflect the synergies and dis-synergies of the transaction).

The former requirements for pro forma adjustments, as well as the amended rules, are summarized below.

<table>
<tr><th>Former Rule</th><th>Amended Rule</th></tr>
<tr><td>

***Income Statement.*** Registrants may only make adjustments to income statements that are:

- directly attributable to the transaction;
- expected to have a continuing impact on the registrant; and
- factually supportable.

***Balance Sheet.*** Registrants may only make adjustments to balance sheets that are directly attributable to the transaction and factually supportable, regardless of whether the impact is expected to be continuing or nonrecurring.

</td><td>

Under the amended rules, registrants are ***required*** to make adjustments based on Transaction Accounting Adjustments and Autonomous Entity Adjustments, which categories must be presented in separate columns, and are ***permitted*** to make Management's Adjustments, each as described below:

***Transaction Accounting Adjustments:***

Transaction Accounting Adjustments reflect only the application of required accounting to the acquisition, disposition or other transaction linking the effects of the acquired or disposed of business to the registrant's audited historical financial statements.

- *Income Statement.* Adjustments to the income statement must depict the effects of pro forma balance sheet adjustments assuming the adjustments were made as of the beginning of the fiscal year presented; and
- *Balance Sheet*. Adjustments to the balance sheet must depict the required accounting for the transaction required by GAAP (or IFRS-IASB, if applicable).

***Autonomous Entity Adjustments***

Autonomous Entity Adjustments are the adjustments necessary to depict the registrant as an autonomous entity if the registrant previously was part of another entity. Autonomous Entity Adjustments must be presented in a separate column from Transaction Accounting Adjustments.

***Management's Adjustments:***

Registrants are permitted to reflect adjustments that depict synergies and dis-synergies of the acquisitions and dispositions for which pro forma financial information is being given if, in management's opinion, such adjustments would enhance an understanding of the pro forma effects of the transaction and certain

</td></tr>
</table>

| Former Rule | Amended Rule |
| --- | --- |
| | conditions are met. The required conditions include the following:<br><br>• Whenever synergies are presented, any related dis-synergies must be presented; and<br><br>• If adjustments reduce expenses, the reduction cannot exceed the amount of the related expense historically incurred during the pro forma period presented.<br><br>When Management's Adjustments are presented, the pro forma financial information must include explanatory notes following specified requirements, including the obligation to include disclosure of the basis for and material limitations of each Management's Adjustment.<br><br>Under the new rules, any forward-looking information supplied is expressly covered by the safe harbor provisions under Securities Act Rule 175 and Exchange Act Rule 3b-6. |

***Financial Statements for Oil and Gas Producers***

Regulation S-X previously did not address certain reporting issues unique to acquisitions of a significant business that includes oil and gas producing activities. Instead, registrants have historically relied on certain FASB guidelines to meet their Rule 3-05 obligations. The amended rules codify such practices. Specifically, under the amendments:

- Rule 3-05 financial statements include the industry-specific disclosures specified in FASB ASC Topic 932 *Extractive Activities – Oil and Gas* on an unaudited basis for each full year of operations presented for the acquired business; and

- Rule 3-05 financial statements may consist of only audited statements of revenues and expenses that exclude depletion, depreciation, and amortization expense, corporate overhead expense, income taxes, and interest expense that are not comparable to the proposed future operations if certain conditions are met.

**Conclusion**

The final rules significantly change, and are expected to improve, registrants' reporting and disclosure obligations with respect to business combinations. As noted above, the amendments will become effective on January 1, 2021, although voluntary early compliance is permitted so long as the rules are applied in their entirety from the date of early compliance.

**Joshua Davidson**
Partner
T: +1.713.229.1527
joshua.davidson@bakerbotts.com

**Mollie Duckworth**
Partner
T: +1.512.322.2551
mollie.duckworth@bakerbotts.com

**A.J. Ericksen**
Partner
T: +1.713.229.1393
aj.ericksen@bakerbotts.com

**Jonathan Gordon**
Partner
T: +1.212.408.2508
jonathan.gordon@bakerbotts.com

**Bryan Henderson**
Partner
T: +1.214.953.6744
bryan.henderson@bakerbotts.com

**Laura Katherine Mann**
Senior Associate
T: +1.713.229.1164
laurakatherine.mann@bakerbotts.com

**Rosemary Parravano Maberry**
Associate
T: +1.214.953.6905
rosemary.maberry@bakerbotts.com