

# Legal Update

## SEC's Proposed Disclosure Improvements for Business Acquisitions and Dispositions

On May 3, 2019, the US Securities and Exchange Commission (SEC) proposed revisions to financial statement disclosures with respect to business acquisitions and dispositions required by Regulation S-X's Rule 3-05 (*Financial Statements of Businesses Acquired or to be Acquired* (Rule 3-05)), Rule 3-14 (*Special Instructions for Real Estate Operations to be Acquired* (Rule 3-14)), Article 11 on *Pro Forma Financial Information* (Article 11), and other related rules and forms. The SEC also proposed revisions to investment companies' financial reporting of acquisitions by proposing a new Rule 6-11 of Regulation S-X (*Financial Statements of Funds Acquired or to be Acquired* (Rule 6-11)) and amending Form N-14 for financial reporting of acquisitions involving investment companies. The investment company related proposed amendments are not addressed in this alert. Through these proposed changes, the SEC aims not only to improve the quality of information being made available to investors as to the potential effects of significant acquisitions and dispositions, but also to promote capital formation.

Among the most important proposed changes would be:

- revising the investment test and income test in determining which business acquisition or disposition is considered significant thereby necessitating the inclusion of target financial statements;
- updating the required contents and period coverage of the acquired business' financial statements; and
- creating a new rule to address financial reporting for fund acquisitions by investment companies.

### Background

When a business combination (other than a real estate operation) involving a registrant has occurred or is probable, the registrant is required by Rule 3-05 to provide separate audited annual, and unaudited interim pre-acquisition, financial statements of that business (Rule 3-05 Financial Statements) if the acquired business is considered to be significant.<sup>1</sup> A registrant currently measures significance by applying the investment, asset and income tests provided in the "significant subsidiary" definition in Rule 1-02(w), substituting 20% for the significance threshold. The specified periods of financial information that a registrant must

provide depends on the relative significance of the acquisition to the registrant.

Pursuant to Rule 3-14, a registrant that has acquired a significant real estate operation (individually, or more than one in the aggregate) must file separate audited annual and unaudited interim abbreviated income statements (Rule 3-14 Financial Statements) with respect to such acquired operation. Only one year of Rule 3-14 Financial Statements is required if (i) the real estate operation is not acquired from a related party, (ii) the registrant discloses the material factors considered in assessing the real estate operation and (iii) the registrant indicates it is not aware of material factors that would cause the reported financial information not to be indicative of future operating results. If any of these conditions is not met, the registrant must file three years of Rule 3-14 Financial Statements.

In addition to filing the requisite target historical financial statements, Article 11 also requires a registrant to produce and file pro forma financial information reflecting the acquisition or disposition. This customarily includes a pro forma balance sheet and pro forma income statements. The pro forma financial information also reflects adjustments to show how the acquisition or disposition might have affected the financial statements had the transaction happened at an earlier time.

Rule 3-05 also applies to registrants that are registered investment companies and business development companies.

## Proposed Amendments

Below we summarize several of the principal proposed amendments.

### *Investment and Income Tests*

In order to determine whether the acquired business' financial statements are required, a

registrant must first determine if the acquisition is significant under Rule 3-05. As discussed above, registrants currently measure the significance by using the three tests prescribed by Regulation S-X: the asset test, investment test and income test.

The investment test considers an acquisition significant if the registrant's investments in the target exceed 20% of the registrant's total assets as of the end of the buyer's most recent fiscal year. In order to closely align the acquisition's economic significance to the registrant, the SEC is proposing instead to compare the registrant's investments to the aggregate worldwide market value of its voting and non-voting equity (aggregate worldwide market value). If the aggregate worldwide market value is not available, the registrant would continue to apply the existing investment test.

The income test considers an acquisition significant if the registrant's share of pre-tax income from continuing operations of the target exceeds 20% of its pre-tax income for the most recent fiscal year. To avoid immaterial acquisitions being deemed significant, the SEC is proposing to revise the income test by adding a new revenue component (revenues less permitted expenses), changing the net income component to *after* income taxes when the registrant and the acquired business have recurring annual revenue, and considering an acquisition significant only if both of these components are exceeded.

### *Financial Statements Submissions in General*

A registrant may be required to file Rule 3-05 Financial Statements relating to up to a three-year period depending on the relative significance of the acquired or to be acquired business. The SEC proposes (i) to limit historical financial statement requirement to up to two years of historical financial statements, (ii) to

dispense with the filing of a third year of Rule 3-05 Financial Statements for an acquisition exceeding 50% significance and (iii) to require financial statements for the “most recent” interim period rather than “any” interim period for acquisitions with significance that exceed 20% but not 40%.

The SEC recognizes the difficulty in, and costs associated with, preparing the required financial statements when a registrant acquires a business (as defined in Rule 11-01(d)), which does not constitute a separate entity, subsidiary or division (e.g., product line). It proposes to allow the registrant to provide abbreviated financial statements (i.e., audited financial statements of acquired assets and assumed liabilities, and statements of revenues and expenses exclusive of corporate overhead, interest and income tax expenses), provided the following conditions, among others, are met:

- the acquired business constitutes less than substantially all of the assets and liabilities of the seller and was not a separate entity, subsidiary, segment, or division during the periods for which the acquired business financial statements would be required;
- separate financial statements for the acquired business have not previously been prepared;
- the statements of revenues and expenses do not omit selling, distribution, marketing, general and administrative, and research and development expenses incurred by or on behalf of the acquired business during the periods to be presented; and
- the notes to the financial statements include certain additional disclosures as to the omitted expenses, cash flows, and a description of how the financial statements presented are not indicative of

the financial condition or results of operations of the acquired business going forward because of the omitted expenses.

Current Rule 3-05 is silent on industry-specific disclosures for acquisitions involving significant oil and gas producing activities. The SEC proposes new Rule 3-05(f) requiring a registrant in this sector to include in its Rule 3-05 Financial Statements the 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. Rule 3-05 Financial Statements may be in the form of 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 (i) substantially all of the revenues of the business are generated from oil and gas producing activities and (ii) the conditions of proposed Rule 3-05(e)(1) through (4) and (e)(6) are met.

As to which accounting standards to use in financial statement preparation, the SEC proposes to allow Rule 3-05 Financial Statements to be prepared in accordance with International Reporting Standards as issued by the International Accounting Standards Board (IFRS-IASB) without reconciliation to U.S. GAAP if the acquired business would qualify to use IFRS-IASB if it were a registrant. It also proposes to permit foreign private issuers that prepare their financial statements using IFRS-IASB to provide Rule 3-05 Financial Statements prepared using home country GAAP to be reconciled to IFRS-IASB rather than U.S. GAAP.

The SEC proposes that Rule 3-05 Financial Statements no longer be required in registration statements and proxy statements once the acquired business is reflected in filed post-acquisition registrant financial statements for a

complete fiscal year. This eliminates the current requirement to provide the Rule 3-05 Financial Statements when these have not been previously filed or have been previously filed but the acquired business is of major significance.

#### ***Financial Statements of Real Estate Operations***

The SEC proposes to amend Rule 3-14 to define a *real estate operation* as “a business that generates substantially all of its revenues through the leasing of real property.”

The SEC found no unique industry considerations that necessitate a differentiated approach for real estate businesses. In order to standardize and simplify the requirements for acquired businesses while retaining the industry-specific disclosure necessary for investors to make informed investment decisions, the SEC proposes to align Rule 3-14 with Rule 3-05 as to, among other things, the significance thresholds, years of required financial statements for acquisitions from related parties, timing of filings and the omission of Rule 3-14 Financial Statements in registration statements and proxy statements once the acquired real estate operation is reflected in filed post-acquisition registrant financial statements for a complete fiscal year.

#### ***Foreign Businesses***

As proposed, Rule 3-05 Financial Statements could be prepared in accordance with IFRS-IASB without reconciliation to US 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 to provide Rule 3-05 Financial Statements prepared using home country GAAP would be permitted to reconcile to IFRS-IASB rather than US GAAP.

#### ***Smaller Reporting Companies and Regulation A***

The amendments would revise Rule 8-04 of Regulation S-X to direct smaller reporting companies to Rule 3-05 for requirements relating to the financial statements of businesses acquired or to be acquired. However, the form and content of these financial statements would continue to be governed by Article 8. The proposed revisions to Rule 8-04 would also apply to issuers relying on Regulation A.

#### **Conclusion**

The SEC is actively seeking comments on its proposed revisions. Although generally beneficial, companies that have concerns about any aspect of the proposal should consider submitting comments to the SEC. The proposed revisions are open for public comment for a period of 60 days from the date of their publication in the Federal Register.

#### ***Additional Information***

As part of the proposed revisions, the SEC has prepared a fact sheet summarizing the proposed amendments and the proposed rules, a copy of which is available at <http://bit.ly/2WCKvQw>. A copy of the proposing release is available at <http://bit.ly/2WtCmxP>.

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## Endnote

<sup>1</sup> See Target and Pro Forma Financial Statement Requirements for Significant Acquisitions, available at <http://bit.ly/2Yfzx45>.

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