SEC Amends Financial Disclosure Rules for Merger & Acquisition Transactions

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Introduction

This First Analysis article discusses the amendments (Amended Rules) adopted by the U.S. Securities and Exchange Commission (SEC) on May 21, 2020 in connection with financial statement disclosures on business acquisitions and dispositions as required by Regulation S-X's (17 C.F.R. §§ 210.1-01 - 12-29) 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 Amended Rules also amended investment companies' financial reporting of acquisitions by adopting a new Rule 6-11 of Regulation S-X (Financial Statements of Funds Acquired or to be Acquired (Rule 6-11)) and revising Form N-14 for financial reporting of acquisitions involving investment companies.

Through the Amended Rules, the SEC aims to improve the quality of information being made available to investors as to the potential effects of significant acquisitions and dispositions, reduce the complexity and costs to disclose this information and promote capital formation. Among the most important amendments contained in the Amended Rules are: (1) revising the investment test and income test used in determining which business acquisition or disposition is considered significant, thereby necessitating the inclusion of target financial statements; (2) updating the required contents and period coverage of the acquired business' financial statements; and (3) creating a new rule to address financial reporting for fund acquisitions by investment companies.

For a comprehensive list of Lexis Practice Advisor resources on the topics covered in this article, see Financial Statements and Reporting Resource Kit.

Background

Under the disclosure framework in existence prior to the Amended Rules, 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. A registrant currently measures significance by applying the investment, asset and income tests provided in the "significant subsidiary" definition in Regulation S-X's 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 (1) the real estate operation is not acquired from a related party, (2) the registrant discloses the material factors considered in assessing the real estate operation, and (3) 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 prepare 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.

Initial Guidance

Below is a summary of the principal amendments to the existing disclosure framework contained in the Amended Rules adopted by the SEC.

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.

Before the Amended Rules, the investment test considered 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 where both entities or businesses are not under common control, the Amended Rules now compare the registrant's investments in and advances to the acquired or disposed business to the aggregate worldwide market value of its voting and non-voting equity (aggregate worldwide market value). The aggregate worldwide market value is the average of the registrant's worldwide market value for voting and non-voting common stock calculated daily for the last five trading days of the registrant's most recently completed month prior to the earlier of either the registrant's announcement date or the acquisition's or disposition's agreement date. This amendment is expressly limited to acquisitions and dispositions. If the aggregate worldwide market value is not available, the registrant would continue to apply the investment test existing before the Amended Rules. Under the Amended Rules, "investments" include the fair value of contingent consideration if required to be recognized at fair value at the acquisition date under U.S. generally accepted accounting principles (GAAP) or International Financial Reporting Standards as issued by the International Accounting Standards Board (IFRS-IASB).

Before the Amended Rules, the income test considered 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 Amended Rules revised the income test by adding a new component (revenues less permitted expenses) which allows the deduction of intercompany eliminations from the target's total revenue from continuing operations when the registrant and the acquired business have material revenue in each of the two most recently completed fiscal years, and consider an acquisition significant only if both the existing and the additional components are exceeded. Therefore, when the revenue component of the income

test applies, both the revenue and net income components must be exceeded to determine whether a subsidiary is significant.

Financial Statements Submissions in General

Before the Amended Rules, 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 has approved the Amended Rules (1) to limit the historical financial statement requirement to cover not more than two years of historical financial statements, (2) to dispense with the filing of a third year of Rule 3-05 Financial Statements for an acquisition exceeding 50% significance, and (3) 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 Regulation S-X's Rule 11-01(d)), which does not constitute a separate entity, subsidiary or division (e.g., product line). The SEC will now allow the registrant to provide abbreviated financial statements prepared in accordance with the presentation requirements prescribed in the Amended Rules (e.g., 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 total assets and total revenues (both after intercompany eliminations) of the 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.
- Separate financial statements for the acquired business have not previously been prepared.
- The acquired business was not a separate entity, subsidiary, operating segment or division during the periods for which the acquired business financial statements would be required.
- The seller has not maintained the distinct and separate accounts necessary to present (and it is impracticable for the seller to prepare) financial statements other than the abbreviated financial statements.

Rule 3-05 had been silent on industry-specific disclosures for acquisitions involving significant oil and gas producing activities. The Amended Rules create a 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 or to be acquired business. Rule 3-05 Financial Statements may consist only of audited statements of revenues and expenses that exclude expenses not comparable to the proposed future operations, such as depreciation, depletion and amortization, corporate overhead, income taxes, and interest for debt that will not be assumed by the registrant or its subsidiaries consolidated if (1) substantially all of the revenues of the business are generated from oil and gas producing activities, (2) the qualifying conditions of Rule 3-05(e)(1) are met, and (3) the disclosures specified in Rule 3-05(e)(2)(iii) are provided.

As to which accounting standards to use in financial statement preparation, the Amended Rules now allow Rule 3-05 Financial Statements to be prepared in accordance with IFRS-IASB without reconciliation to U.S. GAAP if the acquired business would qualify to use IFRS-IASB if it were a registrant.

Upon effectiveness of the Amended Rules, Rule 3-05 Financial Statements are no longer required in registration statements and proxy statements once the acquired business is reflected in filed post-acquisition registrant's financial statements for at least nine months. 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.

Pro Forma Financial Information

The Amended Rules revised pro forma financial information requirements so that the adjustment criteria are broken out into three categories:

- "Transaction Accounting Adjustments" which reflect only the application of required accounting to the transaction
- "Autonomous Entity Adjustments" which reflect the operation and financial position of the registrant as an autonomous entity if it was previously part of another entity –and–
- Optional "Management's Adjustments" depicting synergies and dis-synergies of acquisitions and dispositions for which pro forma effect is being given, if in management's opinion, such adjustments enhance understanding of the pro forma effects of the transaction. As a condition for presenting Management's Adjustments, certain conditions related to the basis and form of presentation must be met.

Financial Statements of Real Estate Operations

The Amended Rules amended 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 aligned 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, and 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 at least nine months.

Financial Disclosures Specific to Investment Companies

An investment company registrant principally invests for capital appreciation and/or investment income and generally does not consolidate its controlled entities or use equity method accounting. Before the Amended Rules, there were no financial reporting rules or requirements specific to an investment company with respect to its acquisitions of investment companies and other types of funds (collectively, acquired funds). Instead, investment companies needed to apply the general requirements of Rule 3-05 and the pro forma financial information requirements in Article 11.

Through the Amended Rules, SEC has (1) added a definition of "significant subsidiary" in Regulation S-X that is specifically tailored for investment companies based on the current Rule 8b-2 definition with some modifications, (2) provided a significant subsidiary test specifically for registered investment companies, (3) implemented a new Rule 6-11 on fund acquisition financial reporting, (4) replaced the current pro forma financial information requirement for investment companies with Rule 6-11(d) requiring investment companies to provide supplemental financial information more relevant to investors, and (5) amended Form N-14 to be consistent with the disclosures required in Rule 6-11 thereby ensuring that investors who acquire securities in a registered offering have the same disclosure that investors receive through financial statement disclosures in shareholder reports.

Foreign Businesses

Pursuant to the Amended Rules, Rule 3-05 Financial Statements may be prepared in accordance with IFRS-IASB without reconciliation to U.S. 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 are permitted to reconcile to IFRS-IASB rather than U.S. GAAP. The Amended Rules also permit an acquired business that would qualify as a foreign private issuer if it were a registrant to use IFRS-IASB rather than U.S. GAAP when the registrant is a foreign private issuer that uses IFRS-IASB.

Smaller Reporting Companies and Regulation A Issuers

The Amended Rules revised 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 revised Rule 8-04 would also apply to issuers relying on Regulation A.

Looking Ahead

The Amended Rules are effective January 1, 2021.

Registrants will not be required to apply the Amended Rules until the beginning of their first fiscal year beginning after December 31, 2020 (the mandatory compliance date). Acquisitions that are probable or consummated after the mandatory compliance date must be evaluated for significance using the Amended Rules. Registrants filing initial registration statements are not required to apply the Amended Rules until an initial registration statement is first filed on or after their mandatory compliance date. In such initial registration statement, all probable or consummated acquisitions, including those consummated prior to the mandatory compliance date, must be evaluated for significance using the Amended Rules.

Registrants are allowed to voluntarily comply with the Amended Rules prior to their mandatory compliance date, provided they apply the Amended Rules in their entirety in advance from the date of the early compliance date.

Previously, the difficulties in timely preparing and filing the required financial statements for acquired businesses have

adversely impacted the ability of some registrants to access the capital markets either to help pay for an acquisition or to fund other capital needs. However, the changes to Rule 3-05 coupled with the ability to voluntarily comply with the Amended Rules immediately could substantially reduce or eliminate this deterrence in many cases. Accordingly, registrants that recently completed or are in the process of completing a significant acquisition should seriously examine whether the Amended Rules will ease their ability to timely access the capital markets without the need to provide financial statements for the acquired business.

The accounting departments of public companies that engage, or are considering engaging, in acquisitions and dispositions should review the Amended Rules carefully to determine how these amendments will impact upcoming disclosures.

Companies should assess how the Amended Rules would impact their disclosure to determine whether they want to voluntarily comply with the Amended Rules in advance of their mandatory compliance date, recognizing that voluntary compliance requires complete compliance.

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Laura Richman's wide-ranging corporate and securities practice has a strong focus on corporate governance issues and public disclosure obligations. Laura's practice includes Securities and Exchange Commission reports, such as proxy statements and annual, quarterly and current reports. She advises on executive compensation disclosure, insider trading regulation and Dodd-Frank and Sarbanes-Oxley compliance. Laura represents listed company clients with respect to stock exchange compliance matters. She advises clients on governance policies and other board and shareholder matters. In addition, her practice includes representing clients on transactions such as securities offerings and mergers and acquisitions, as well as providing general securities, corporate, limited liability company and contract advice. Laura has practiced with Mayer Brown since 1981.

With regard to securities transactions, Laura represents issuers and underwriters in public and private offerings of debt and equity securities (both initial public offerings and offerings of seasoned, public companies), including guidance on federal and state securities law compliance. She also advises issuers in connection with the securities law aspects of employee benefit plans and dividend reinvestment plans. Other transactional matters in which Laura represents corporate clients include acquisitions and dispositions of assets or stock, restructurings (such as holding company formation) and going-private transactions. She also advises investors in leveraged buyout transactions, and represents financial institutions that take equity positions in companies. Laura advises clients on shareholder rights plans and anti-takeover protection provisions.

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Anna Pinedo is a partner in Mayer Brown's New York office and a member of the Corporate & Securities practice. She concentrates her practice on securities and derivatives. Anna represents issuers, investment banks/financial intermediaries and investors in financing transactions, including public offerings and private placements of equity and debt securities, as well as structured notes and other hybrid and structured products.

She works closely with financial institutions to create and structure innovative financing techniques, including new securities distribution methodologies and financial products. She has particular financing experience in certain industries, including technology, telecommunications, healthcare, financial institutions, REITs and consumer finance. Anna has worked closely with foreign private issuers in their securities offerings in the United States and in the Euro markets. She also works with financial institutions in connection with international offerings of equity and debt securities, equity- and credit-linked notes, and hybrid and structured products, as well as medium term note and other continuous offering programs.

In the derivatives area, Anna counsels a number of major financial institutions acting as dealers and participants in the commodities and derivatives markets. She advises on structuring issues as well as on regulatory issues, including those arising under the Dodd-Frank Act. Her work focuses on foreign exchange, equity and credit derivatives products, and structured derivatives transactions. Anna has experience with a wide range of transactions and structures, including collars, swaps, forward and accelerated repurchases, forward sales, hybrid preferred stock and off-balance sheet structures. She also has advised derivatives dealers regarding their Internet sites and other Internet and electronic signature/delivery issues, as well as on compliance matters.

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Mike Hermsen is a partner in Mayer Brown's Corporate & Securities Group. Mike has an extensive practice that focuses on securities matters, including the representation of issuers in securities offerings and liability management transactions, corporate clients in connection with compliance, reporting and stock exchange matters and companies, boards of directors and management on, among other things, corporate governance matters and executive compensation disclosures and reporting. Mike has been included in *The Best Lawyers in America* in the practice areas of Securities/Capital Markets Law and Securities Regulation for over a decade and *Legal 500* recommends Mike in "Capital Markets – Equity Offerings" noting Mike has "unsurpassed knowledge of SEC rules." In addition, Mike is frequently cited in the media regarding new regulatory initiatives.

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G earned his LLM from Columbia Law School, where he served as a student senator and graduated as the class speaker, a Harlan Fiske Stone scholar and a recipient of the Parker School Recognition of Achievement in International and Comparative Law. He earned his JD, with honors, from the Ateneo Law School and his BS in Accountancy, with honors, from De La Salle University.

G's prior professional experiences include being (i) a capital markets associate in another global law firm in New York, (ii) the legal director of a multinational fast-food chain headquartered in the Philippines, where he gained extensive experience in managing legal risks in various business activities such as business development and expansion, customer relations, operations, real estate, franchising, marketing, human resources, purchasing, finance, corporate communications, tax and government relations, (iii) a member of the faculty of the Ateneo Law School and (iv) a tax associate in a tier-one law firm in the Philippines. G is also a lawyer and a certified public accountant in the Philippines