SEC Revises Financial Statement Disclosure Requirements for Acquisitions and Dispositions

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The SEC recently amended its disclosure requirements for historical and pro forma financial statements arising from acquisitions and dispositions.[1] While the revisions are fairly technical, overall they should reduce disclosure burdens and make it easier for public companies to pursue these transactions. The revisions also provide a useful reminder that public companies must sometimes disclose financial information even for very small acquisitions and should therefore strive to obtain reliable financial statements in every acquisition.

The new rules take generally effect at the beginning of each public company's fiscal year commencing after December 31, 2020, but companies may comply early if they apply the new rules in full upon early compliance. Financial statements for transactions initially reported on Form 8-K before the applicable effective date will continue to be governed by the existing rules, even if the financial statements are filed after the effective date.

Improvements to Financial Tests of "Significance"

Background. Whether or not a public company must provide financial statement disclosure for acquisitions and dispositions depends in large measure upon whether or not the target company is "significant" relative to the public company. The SEC uses three separate tests of significance: an investment test, an asset test and an income test. The target need only satisfy a single test to trigger disclosure requirements. Each test generally compares the relevant metric for the target company (or group of related companies) against the same or a similar metric for the public company, and the disclosure requirements are triggered if the relevant ratio exceeds 20%, with more extensive disclosure required when the ratio exceeds 40%. In these latest revisions, the SEC modified only two of the tests, the investment test and the income test.

Revised Investment Test. The revised investment test generally compares the purchase price of the target business (a measure of fair value) to the market capitalization of the public company's common equity (also a measure of fair value), a change from the current investment test, which uses the public company's total assets (a measure of book value). Because a public company's market capitalization typically exceeds its total assets, we expect that fewer transactions will qualify as "significant" under the revised investment test. The public company's market capitalization is based on the average aggregate worldwide market value of its voting and non-voting common equity over the last five trading days of the month before the earlier of the announcement date or the date of the relevant agreement. If no market capitalization is available, the investment test defaults back to a comparison against the total assets of the public company. Because the revised investment test compares two measures of fair value rather than one measure of fair value and one measure of book value, it should normally generate more logical results.

The new investment test explicitly addresses the treatment of contingent consideration. The purchase price of the target company must include the fair value of contingent consideration, to the extent required to be recognized at fair value at the acquisition date for accounting purposes; otherwise, the purchase price must include all contingent consideration for which the likelihood of payment is more than remote.

Revised Income Test. As currently in effect, the income test generally compares the target company's consolidated pre-tax income from continuing operations for the most recently completed fiscal year (excluding non-controlling interests) against the same metric for the public company. This test has often been criticized as susceptible of producing anomalous results, particularly for public companies with income near break-even. To address this concern, the revised income test adds a new revenue component. The revenue component measures the target company's total revenues from continuing operations against the same metric for the public company. To be significant, the target company must satisfy *both* the income test and the new revenue test. If the target company is significant, the number of years of financial statements required to be provided (as described below) will be based on the lower of the income test or revenue test. The revenue test does not apply, however, when either the public company or the target company did not have material revenue in each of the two most recently completed fiscal years.

Using Pro Forma Information to Measure Significance. Public companies that have completed one or more recent acquisitions would usually prefer to measure significance using pro forma financial statements reflecting those acquisitions, since those pro forma financial statements presumably provide more accurate depiction of the size of the public company. Under the new rules, a public company may measure significance using pro forma financial statements that depict *only* significant business acquisitions and dispositions consummated *after* the end of the most recently completed fiscal year and that reflect only "Transaction Accounting Adjustments" (described in further detail below) and no other adjustments. In the case of an acquisition, this option is available only if the company has filed both the target company's required historical financial statements and the related pro forma financial statements.

The use of pro forma financial statements to measure significance is optional, even in the case of dispositions. However, once a public company uses pro forma financial statements for this purpose, it must continue to do so until the filing of its next annual report on Form 10-K.

Fewer Historical Financial Periods to Disclose

The SEC reduced the maximum number of years for which historical financial statements of the target company must be provided. Under existing rules, a public company must disclose one, two or three years of historical financial statements of the target company (plus relevant interim periods) depending on whether the target company is significant at the 20%, 40% or 50% level. The revised rules eliminate the third category of disclosure; as a result, public companies will no longer have to provide more than two years of annual financial statements for target companies.

The revised rules further provide that, if the target company is not more than 40% significant, then any requirement to supplement annual financial statements with interim period financial statements need only include the interim period that commences after the disclosed fiscal year; interim period financial statements for the comparative prior period are not required. However, the pubic company must provide the comparative prior period interim financial statements if they would reveal material trends that are not otherwise apparent.

Individually Insignificant Acquisitions and Undisclosed Significant Acquisitions

In general, public companies need not provide financial information for target companies that are not more than 20% significant and, under Form 8-K, public companies have a 71-day grace period (after the initial four business day deadline) to provide historical and pro forma financial statements for acquisitions that are more than 20% significant. However, the disclosure requirements of most registration statements and certain proxy statements can override these general rules, both as currently in effect and as revised.

As under the existing rules, public companies filing most registration statements (or conducting a shelf offering under an effective registration statement) or certain proxy statements must provide historical and pro forma financial statements for any acquisition that exceeds 50% significance, including both completed acquisitions not yet required to be reported on Form 8-K and *pending* acquisitions.

In addition, under the new rules, if recently completed or pending acquisitions are *individually* insignificant or are not yet required to be filed but in the aggregate exceed 50% significance, then a public company filing a registration statement or certain proxy statements must include or incorporate by reference pro forma financial statements reflecting *all* acquisitions since the date of the most recent audited balance sheet. These acquisitions include (a) completed acquisitions below 20% significance (whose financial statements would never otherwise be required), (b) pending acquisitions below 50% significance (whose financial statements would not otherwise be required until after consummation) and (c) recently completed acquisitions between 20% and 50% significance (whose financial statements would not otherwise be required until the expiration of the grace period under Form 8-K). When this pro forma disclosure requirement applies, the public company must also file historical financial statements for at least the most recent fiscal year and most recent interim period for any target company that is individually significant at the 20% level, even if the grace period under Form 8-K has not yet lapsed.[2] The SEC eliminated the current requirement to provide historical financial statements representing the "majority" of individually insignificant businesses, which should help to reduce overall disclosure burdens.

To facilitate compliance with the new rules, highly acquisitive companies should consider making it a routine practice to obtain, when practicable, GAAP-compliant financial statements or, preferably, audited financial statements of target companies, even when those companies do not meet the threshold of significance. Obtaining that information will help the company maintain the effectiveness of its internal control over financial reporting and its disclosure controls and procedures. For example, having access to reliable target company financial information will enable the company to determine, in the first instance, whether or not it has an obligation to file aggregated pro forma information at a later point in time and, if so, to prepare and timely file the necessary pro forma financial information. Similarly, acquisitive companies should seek to obtain historical financial statements of target companies as rapidly as possible so as to be well positioned to quickly consummate later registered offerings or proxy solicitations that might require such disclosure. Companies that fail to plan for these circumstances risk delaying or even derailing necessary or desirable offerings or other transactions.

Reduced Pro Forma Disclosure Requirements for Dispositions

The revised rules raise the significance threshold for providing pro forma financial statements for dispositions from 10% to 20%. The new rules also revised the significance tests for dispositions to match those for acquisitions.

Increased Burdens for Smaller Reporting Companies

In revising Regulation S-X, the SEC prioritized consistency of financial statement disclosure over relief for smaller reporting companies. The new rules largely update the filing requirements for smaller reporting companies to match those applicable to larger companies, which will generally increase disclosure requirements for smaller reporting companies. For example, the new rules will now require smaller reporting companies to provide pro forma financial statements for the disposition of significant businesses on Form 8-K as well as in certain registration statements and proxy statements.

Limited Relief for Partial Acquisitions

Public companies acquiring only a portion of a business – such as a product line – sometimes encounter difficulty obtaining the financial information they must disclose. In the revised rules, the SEC provided limited relief for acquisitions that, while significant to the public company, comprise only a small portion of the seller's business. The relief is narrow and applies only when certain conditions are met. Public companies can present "abbreviated" financial statements for an acquired business if (a) it comprised not more than 20% of the assets and revenues of the seller, (b) separate financial statements for the business have not been prepared, (c) it was not a separate entity, subsidiary, operating segment or division of the seller, and (d) necessary records have not been maintained that would make it practicable to prepare full financial statements. "Abbreviated" financial statements generally include a statement of assets acquired and liabilities assumed and a statement of revenues and expenses, excluding corporate overhead, interest on debt not assumed and income tax expense.

Earlier Termination of Reporting Obligations

The new rules generally shorten the period during which public companies must continue to provide or incorporate by reference separate financial statements of a target company and related pro forma financial statements. Under the new rules, a public company need not provide those financial statements after the target company has been included in the public company's consolidated financial statements for at least nine months (in the case of acquired businesses between 20% and 40% significant) or one year (for acquired businesses more than 40% significant). The revised rules also eliminate the current requirement to continue to present target financial statements of "major significance" (e.g., 80% significant) for several years after the acquisition.

Modification of Presentation Requirements for Pro Forma Financial Statements

The new rules modify and significantly expand the presentation requirements for pro forma financial statements.

Types of Pro Forma Adjustments. The rules allocate pro forma adjustments to one of three distinct categories:

- *Transaction Accounting Adjustments*, which reflect only the application of required accounting to the transaction;
- *Autonomous Entity Adjustments*, which are adjustments necessary to reflect the operations and financial position of a company that was previously part of another entity as an autonomous entity; and
- *Management's Adjustments*, which give companies the discretion to depict synergies and dis-synergies of the transaction if, in management's judgment, the adjustments would enhance investors' understanding of the effects of the transaction. Existing rules do not permit these sorts of discretionary adjustments; accordingly, this change reflects a significant liberalization of permitted pro forma disclosures. This flexibility does not come without costs; see below for new disclosure requirements applicable to

Management's Adjustments.

Transaction Adjustments and Autonomous Entity Adjustments are obligatory, when applicable, and must be presented as separate columns in the pro forma financial statements. Moreover, if the financial statements give pro forma effect to more than one transaction, they must present the pro forma effect of each transaction in a separate column.

Management's Adjustments, on the other hand, are optional and <u>may not</u> be presented in columnar format on the face of the pro forma financial statements. Instead, apparently in order to downplay the significance of these discretionary adjustments, Management's Adjustments may only be presented in the explanatory notes to the pro forma financial statements and must be reconciled to the relevant amounts on the face of those financial statements.

The explanatory notes must disclose revenues, expenses, gains, losses and related tax effects that will not recur in the income of the company beyond 12 months after the transaction. In transactions involving contingent consideration, companies must describe the contingent consideration arrangements, the basis for determining the amount of payments or receipts, and an estimate of the range of undiscounted outcomes or, if a range cannot be estimated, that fact and the reasons why. If significantly different results may occur, the company must provide additional pro forma presentations giving effect to the range of possible results. Disclosures of Autonomous Entity Adjustments must give a fair and balanced presentation, including material assumptions.

Outside the pro forma financial statements, companies may not present incomplete pro forma information; pro forma information (including summaries) may not exclude material transactions for which pro forma effect is required to be given.

Conditions to the Presentation of Management's Adjustments. In order to present any Management's Adjustment, the adjustment must have a reasonable basis, the adjustment may reflect only the impact on the financial statements assuming that the relevant synergies and dis-synergies existed at the beginning of the pro forma period and, significantly, the adjustments must include all adjustments necessary in the opinion of management for a fair presentation of the pro forma information, including any related dis-synergies. This last requirement for a "fair presentation" may significantly curtail companies' desire to include Management's Adjustments, since the inclusion of any such adjustment may create litigation exposure for the alleged omission of related dis-synergies. Any forward-looking information in Management's Adjustments will be eligible for the safe harbor rules under Rule 175 and Rule 3b-6.

Further, the explanatory notes must disclose the basis for and material limitations of each Management's Adjustment, including any material assumptions or uncertainties, an explanation of its method of calculation, if material, and the estimated time frame for achieving the relevant synergies and dis-synergies.

If a company discloses pro forma amounts that reflect Management's Adjustments anywhere in a filing outside the pro forma financial statements, the company must also present, with equal or greater prominence, the amounts to which they are reconciled and a cross-reference to the reconciliation.

Management's Adjustments may have to be Updated. Significantly, the new rules require that, if any Management's Adjustments are initially presented and the pro forma financial statements are later included or incorporated by reference in a registration statement, proxy statement or other filing, the Management's Adjustments must be updated to the most recent practicable date. This updating requirement is new, and it may present an unanticipated stumbling block for management to execute a transaction quickly, since the company may no longer be able to incorporate by reference pro forma financial statements filed at the time of the transaction. As a result, companies should include Management's Adjustments only after careful consideration of the future obligations they may create.

[1]This alert does not address the specialized disclosure requirements for real estate operations, investment companies, business development companies or foreign issuers.

[2] For acquisitions that are significant at the 40% level, companies would still have until the end of the grace period to provide historical financial statements covering the earlier of the two years of required annual financial statements and the comparative interim prior period. Because these financial statements cover earlier periods, they may already be available, and issuers should consider including them to mitigate the risk of alleged omissions of material information./p>

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