SIDLEY UPDATE

SEC Substantially Improves Financial Disclosure Rules Relating to Business Acquisitions and Dispositions

May 26, 2020

The SEC's long-expected reforms to Regulation S-X regarding financial disclosure for business acquisitions and dispositions were published as final amendments on May 21, 2020. Most of the final amendments are substantially in line with the SEC's May 2019 proposing release, on which we commented in our May 2019 Sidley Update. Part of the SEC's overall initiative to improve and streamline disclosure, the final amendments reflect a comprehensive re-thinking — and we believe substantial improvement — of a business combination disclosure system that has in many ways vexed registrants and their professional advisors for decades. The final amendments will become effective on January 1, 2021, but issuers are permitted to voluntarily comply with the final amendments in advance of the effective date.

Executive Summary of Amendments

Broadly speaking, the final amendments:

- require the financial statements of the acquired business to cover only up to the two most recent fiscal years (reduced from three fiscal years), in addition to interim period disclosure;
- update the tests used to determine the "significance" of an acquisition or disposition to generally reduce the incidence of anomalous "false positive" results and thereby help issuers avoid burdensome disclosure requirements for transactions that are not "material" in the common-sense meaning of the word;
- expand the use of pro forma financial information in measuring significance;
- permit pro forma financial information to include "management adjustments" reflecting reasonably estimable synergies and other transaction effects that have occurred or are reasonably expected to occur as a result of the transaction;
- no longer require the issuer to include separate acquired business financial statements, so long as the business has been included in the issuer's post-acquisition audited annual financial statements for either nine months or a complete fiscal year, depending on the significance of the acquired business;
- modify and enhance the required disclosure for the aggregate effect of acquisitions for which financial statements are not required or are not yet required;
- increase the significance threshold for dispositions from 10% to 20% to conform with the minimum significance threshold for acquisitions;
- for foreign businesses, permit the use of, or reconciliation to, International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB") in certain circumstances;
- align Rule 3-14, the comparable rule that applies to real estate operations, with Rule 3-05 where no unique industry considerations exist; and

- codify existing practices relating to aspects of target company financial statements that are unique to oil and gas acquisitions.

All of these changes are welcome improvements and, in our view, will move the relevant U.S. disclosure requirements toward a more principles-based regime. In particular, the change allowing pro forma financial statements to reflect future synergies and other effects of a business combination will now provide management with the ability to provide investors with more meaningful pro forma information that incorporates management's estimate of the anticipated impact of the transaction on pro forma operating results.

Target Company Financial Statements for Significant Acquisitions

Regulation S-X sets out rules for preparing and disclosing historical target company financial statements and pro forma financial information in connection with significant acquisitions and dispositions. These historical financial statements and pro forma financial information are generally required to be included in registration statements for securities offerings under the Securities Act of 1933. They are also required to be included in filings on Form 8-K that disclose material acquisitions or dispositions (either in the initial Form 8-K or in an amended Form 8-K filed within 71 days after the original filing deadline).

Regulation S-X provides that historical target company financial statements are required depending on the significance of the acquired business, measured using three tests: the investment test, the income test and the asset test.[1] (These three tests were described in our May 2019 Sidley Update regarding the proposed amendments.) If any one of the three tests exceeds the minimum 20% threshold, then audited financial statements for the target company must be included in the offering document as well as pro forma financial information showing the effect of the acquisition.

The final amendments reduce the maximum number of years of audited historical target financial statements that must be filed from three years to two. Prior to the final amendments, three years of historical target financial statements were required if the acquisition exceeded 50% on any of the significance tests. The final amendments require only two years if significance is triggered at the 40% level or above. In making this change, the SEC acknowledged that the third and oldest year of historical target financial statements is inherently of limited utility to investors, and the elimination of this requirement significantly reduces the burden on registrants in preparing for offerings.

In addition, if at least one significance test exceeds 20% but none exceeds 40%, the final amendments require financial statements only for the "most recent" interim period rather than "any" interim period. This revision eliminates the need to provide a comparative interim period when only one year of audited target company financial statements is required. In the SEC's view, providing a comparative interim period when there is no requirement for a corresponding comparative annual period may have limited utility for investors and creates an additional burden on issuers to prepare that information. Focusing on the most recent interim period provides the most relevant and material information to investors. However, notwithstanding this accommodation from the SEC, note that auditors may still require prior-year interim financials for purposes of comfort.

It is important to note that if an issuer's acquisition of the target company is subject to a shareholder vote, the requirements of Form S-4 or Form F-4 will control what historical financial statements must be included for the target company in the proxy statement or proxy statement/prospectus. Consider, for example, an acquiring issuer that files a Form S-4 proxy statement/prospectus in order to obtain any required shareholder vote. Notwithstanding the maximum two-year period called for in the final amendments, Form S-4 could still require three years of historical financial statements for the target company in the transaction subject to the shareholder vote. However, if Regulation S-X requires that issuer to include in its proxy statement/prospectus historical financial statements for a target in an unrelated acquisition, the modified time period requirements set forth in the final amendments would apply to that unrelated target company.

Modifications to the Investment Test and the Income Test to Measure Significance

Investment Test

Prior to the final amendments, the investment test compared the issuer's investments in the target business (generally, the purchase price in the acquisition) against the acquiring issuer's total assets. Under the final amendments, the investment test has been revised to compare the issuer's investments in the acquired business to the aggregate worldwide market value of the issuer's voting and non-voting common equity — i.e., instead of total assets. The rationale for this change is that it will help eliminate anomalous "false positive" results from comparing the target company's market value to the acquirer's historical asset book value, which for many companies bears no relation to the actual value of the company. In place of that comparison, the final amendments effectively require the comparison of the acquirer's market value to what is generally the purchase price of the target company. As a result, the final amendments provide for an apples-to-apples test that should render a more meaningful measure of the significance of the acquisition to the issuer.

While the aggregate worldwide market value of the acquirer generally is readily available information that can be objectively determined by the market, there are cases (such as for an IPO issuer) where this measure is not available. In these cases, the final rules continue to require the use of the book value of total assets of the issuer and its consolidated subsidiaries for the investment test. For this reason, this revision affords less relief to IPO candidates than for companies that are already public.

The final amendments also require that "investments in" the target company include the fair value of contingent consideration (such as earn-outs), so long as that contingent consideration is required to be recognized at fair value by the issuer at the acquisition date under U.S. GAAP or IFRS, as applicable. However, if applicable accounting standards don't require the contingent consideration to be recognized at fair value, then all contingent consideration must be included, except to the extent payment of all or any portion of the contingent consideration is remote.

Income Test

Currently, the income test consists of a single component, based on income from continuing operations before income taxes. For early-stage issuers that do not anticipate positive net income for several years — or issuers with marginal net income or loss in a recent fiscal year — using only the income component could have the effect of requiring financial statements for otherwise immaterial acquisitions. Consider the example of a substantial, rapidly growing company that is not yet generating net income because it is investing for growth. That company could experience a "false positive" test result from the acquisition of a vastly smaller company making losses that, while immaterial to the acquirer, nonetheless exceed the acquirer's own bottom line by 20% or more. Under the final amendments, a new revenue component[2] has been added to the income test to help mitigate against these false positive results.

Where the issuer and the target company have "material" annual revenue for each of the most recently completed two fiscal years, the target company must have at least 20% of both revenue and operating income to trigger the test. Also, under those circumstances, the issuer may use the lower of the revenue component and the income component to determine the number of periods for which target company financial statements are required. If the target company does not exceed both of these components by at least 20%, the acquisition is not considered significant for purposes of the income test. While the SEC did not define "material" in its two year lookback on revenue, in practice we expect materiality to be judged for each of the acquirer and the target in relation to its own operations.

In one significant departure from the proposed amendments, the SEC abandoned its proposal to modify the calculation of income or loss from continuing operations to be *after* income taxes, as opposed to the current rules which require the calculation *before* income taxes. The SEC was persuaded by commenters that using *after* tax information may result in significance determinations that are less consistent and meaningful because they could be distorted due to factors such as the tax status of the entity or the volatility of income taxes. Therefore, the final amendments retain the current requirement to use income or loss from continuing operations *before* income taxes ("consolidated income or loss") for purposes of the income test.

In addition, as contemplated by the proposed rules, the final rules provide that the income component is determined by comparing the "absolute value" of the consolidated income or loss of the target company with that of the issuer. If the revenue component does not apply, and the absolute value of the issuer's consolidated income or loss is at least 10% lower than the average of absolute value of those amounts for the last five years, then the issuer may use the five-year average of the absolute value of consolidated income or loss. Note that, for calculating average income, the final amendments differ from current SEC staff interpretation, which indicates that zero should be used for loss years in computing the average. Under the final amendments, average income should be calculated using the absolute value of the loss or income amounts for each year and then calculating the average.

The Use of Pro Forma Financial Information to Measure Significance

Under the current rules, determinations of significance are generally required to be made by comparing the most recent annual consolidated financial statements of the target company to those of the issuer prior to the date of acquisition. In applying the significance tests, the issuer is permitted to use pro forma, rather than historical, financial information in limited circumstances — that is, where the issuer made a significant acquisition after its latest fiscal year-end and filed target company financial statements and pro forma financial information relating to the acquisition on Form 8-K with the SEC.

Under the final amendments, the issuer is permitted to measure significance using filed pro forma financial information that depicts significant business acquisitions and dispositions consummated after the latest fiscal year end for which the issuer's financial statements are required to be filed. However, the issuer may do so only with respect to acquisitions or dispositions for which historical target company financial statements and pro forma financial information have been filed with the SEC (including in initial registration statements).

Note that when using pro forma financial information to determine significance, issuers are *not permitted* to include any "management's adjustments" or "autonomous entity adjustments." However, issuers are *required* to make "transaction accounting adjustments." (See "Pro Forma Financial Information and Permitted Adjustments" below for a description of those three types of adjustments.)

In addition, the SEC modified the proposed rule change to codify current practice requiring an SEC registrant that uses pro forma financial information to measure significance to continue to do so until its next annual report on Form 10-K or Form 20-F.

Pro Forma Financial Information and Permitted Adjustments

Under Section 11-02 of Regulation S-X, as in effect prior the final amendments, if an acquisition of a significant business has occurred or is probable, the issuer is required to provide pro forma financial information showing the impact of the acquisition. Specifically, the issuer must provide a pro forma condensed income statement and a pro forma condensed balance sheet for the most recent fiscal year and any subsequent interim period (for the pro forma income statement) and for the most recent balance sheet date (for the pro forma balance sheet). Pro forma financial information (a balance sheet and income statement) is also required for dispositions of a significant portion of a business if that disposition has occurred or is probable and is not fully reflected in the issuer's financial statements.

Prior to the final amendments, the only adjustments that were appropriate in the presentation of the pro forma income statement were those directly attributable to the transaction that are factually supportable and are expected to have a continuing impact on the registrant. The pro forma balance sheet, on the other hand, reflects pro forma adjustments that are directly attributable to the transaction and factually supportable, regardless of whether the impact is expected to be continuing or nonrecurring, because the objective of the pro forma balance sheet is to reflect the impact of the transaction on the issuer's financial position as of a single point in time (i.e., the balance sheet date).

Under the final amendments, the existing pro forma adjustment criteria have been replaced, and in effect substantially expanded, with three categories of adjustments:

- "*Transaction accounting adjustments,"* which are effectively the pro forma adjustments that are permitted under the SEC's existing rules and are intended to depict adjustments relating to the accounting for the transaction required by U.S. GAAP or IFRS;

- "*Autonomous entity adjustments,"* which apply where the issuer was a part of another entity, and presentation of pro forma financial information is necessary to reflect the operations and financial position of the issuer as a stand-alone, autonomous entity; and

- "*Management's adjustments,*" which are intended to reflect the synergies and other effects of the transaction that are both reasonably estimable and have occurred or are reasonably expected to occur, such as closing facilities, discontinuing product lines, terminating employees and executing new or modifying existing agreements.

Under the final amendments, "management's adjustments" are *optional*, but "transaction accounting adjustments" and "autonomous entity adjustments" are *mandatory* in the preparation of pro forma financial information.

Specifically, the final amendments require that "transaction accounting adjustments" and "autonomous entity adjustments" be included in the calculation of the historical and pro forma per share data presented on the face of the pro forma condensed statement of comprehensive income. The SEC believes that including these adjustments on the face of the pro forma financial information will help achieve consistency in the application of the pro forma requirements and will simplify compliance. The final amendments also require issuers to disclose revenues, expenses, gains and losses and related tax effects that will not recur in the income of the issuer beyond 12 months after the transaction.

As for "management's adjustments," the SEC has determined that those adjustments may be presented if in management's opinion those adjustments would enhance an understanding of the pro forma effects of the transaction. Issuers are encouraged, but not required, to provide those adjustments, but *only if* the following conditions are met:

- There is a reasonable basis for each adjustment;

- The adjustments are limited to the effect of those synergies and dis-synergies on the historical financial statements that form the basis for the pro forma income statement as if the synergies and dis-synergies existed at the beginning of the fiscal year presented;

- If those synergy and dis-synergy adjustments reduce expenses, the reduction may not exceed the amount of the related expense historically incurred during the pro forma period presented; and

- The pro forma financial information includes a statement that confirms that the pro forma financial information reflects all "management's adjustments" that are, in management's opinion, necessary to a fair statement of such information.

Notably, when synergies are presented, any related dis-synergies must also be presented. Additionally, explanatory notes must include disclosure of the basis for and material limitations of each adjustment. Those explanatory notes must also include any material assumptions or uncertainties of such adjustment, an explanation of the method of the calculation of the adjustment, if material, and the estimated time frame for achieving the synergies and dis-synergies of such adjustment.

The final amendments require that "management's adjustments" be presented in the explanatory notes to the pro forma financial information, in the form of reconciliations of pro forma net income from continuing operations attributable to the controlling interest and the related pro forma earnings per share data to such amounts after giving effect to "management's adjustments." The SEC included this requirement in the final amendments to achieve consistency between pro forma financial information presentations that include "management's adjustments" and those that do not. The SEC also recognized that the line item format of pro forma financial information may not be well-suited to "management's adjustments."

As we noted in our Sidley Update on the proposed amendments, the inclusion of “management’s adjustments” represents a significant departure from past practice and provides flexibility to include forward-looking information that depicts certain anticipated synergies, efficiencies and other transaction effects identified by management. Significantly, the SEC recognized that “management’s adjustments” may contain forward-looking information and amended the rules to include an instruction indicating that any forward-looking information supplied is expressly covered by the safe harbor provisions of Rule 175 under the Securities Act of 1933 and Rule 3b-6 under the Securities Exchange Act of 1934. Nevertheless, to the extent that information of this nature is included, underwriters and their counsel will need to conduct a heightened level of due diligence with respect to the pro forma financial information and, in particular, the forward-looking information, and all transaction parties — including issuers — will need to be comfortable with the potential liability risk.

Omission of Target Company Financial Statements for Major Significant Transactions

Under the final amendments, the SEC has eliminated the current requirement to provide target company financial statements when the target company has been reflected in the issuer’s post-acquisition financial statements for a complete fiscal year, even when the target company exceeds the 80% significance level. The SEC acknowledged that the utility of pre-acquisition periods diminishes over time after the acquired business is reflected in post-acquisition results. In addition, even without target company financial statements, the issuer is still required under Regulation S-X — and other SEC disclosure rules, including Rule 10b-5 — to disclose material information to ensure that the disclosure is not misleading.

Disclosure Requirements for Individually Insignificant Acquisitions

Under Regulation S-X, as in effect prior to the final amendments, audited historical pre-acquisition financial statements are generally not required if the target business does not exceed 20% significance (or does not exceed higher significance levels, in other prescribed circumstances). However, if the aggregate impact of “individually insignificant businesses” acquired since the date of the issuer’s most recent audited balance sheet exceeds 50%, audited pre-acquisition financial statements covering at least the substantial majority of the businesses acquired must be included in the offering document. Issuers must also provide related pro forma financial information reflecting those acquisitions.

Under the final amendments, issuers are still required to provide pro forma financial information depicting the aggregate effects of all such businesses in all material respects. However, rather than filing financial statements covering the “substantial majority” of the acquired businesses, under the final amendments target company financial statements will be required only for those businesses whose individual significance exceeds 20%. As a result, issuers that have made multiple acquisitions could be in a position where aggregated *pro forma* financial information is required, but no *historical* financial statements are required if none of the targets exceeded the 20% test.

Significance Thresholds for Dispositions

As noted above, prior to the final amendments, pro forma financial statements are required if the significance of a disposition exceeds 10% (as opposed to 20% for acquisitions). The final amendments raise the significance threshold for dispositions from 10% to 20%. The tests used to determine significance have been conformed to those relating to acquisitions.

Financial Statements for Foreign Businesses

Regulation S-X currently permits the use of IFRS financial statements (that comply with IASB) for foreign businesses. The final amendments permit target company financial statements to be prepared in accordance with IFRS without reconciliation to U.S. GAAP if the target company would qualify to use IFRS if it were an SEC registrant. The final amendments also permit foreign private issuers that prepare their financial statements using

IFRS to provide target company financial statements prepared using home country GAAP (i.e., not IFRS or U.S. GAAP) to be reconciled to IFRS rather than U.S. GAAP. Additional accommodations are available for businesses that are reconciling to IFRS for the first time.

Financial Statements for Real Estate Operations

Under Regulation S-X, as in effect prior to the final amendments, the financial statement requirements for real estate operations (under Rule 3-14 of Regulation S-X) have historically differed from the target company financial statement rules for other businesses (under Rule 3-05 of Regulation S-X). For example, the SEC generally requires issuers to provide only one year of financial statements for real estate operations. According to the SEC's adopting release, audited financial statements for a real estate operation are rarely available from the seller without additional effort and expense, because most real estate managers do not maintain their books on a U.S. GAAP basis or obtain audits. In addition, historical financial statements for real property do not usually provide significant information about the trends and factors that are most likely to affect future operations.

The final amendments were adopted as proposed. They align the target company financial statement requirements for real estate operations under Rule 3-14 with those for other businesses under Rule 3-05, consistent with the final amendments discussed in this Update, except where unique real estate industry considerations exist.

Financial Statements for Businesses That Include Significant Oil and Gas Producing Activities

Oil and gas acquisitions raise unique accounting issues that Regulation S-X does not currently address. As a result, issuers have historically adopted a practice of relying instead on Financial Accounting Standards Board ("FASB") oil and gas guidelines and case-by-case dispensation from the SEC staff in order to comply with Rule 3-05's target company financial statement requirements. The final amendments formally codify these practices in new Rule 3-05(f) of Regulation S-X.

It is not uncommon for an oil and gas acquisition to be structured as the purchase of oil and gas assets that are not held in a separate subsidiary or division. As a result, even when those oil and gas properties are large enough to meet Regulation S-X's significance tests, those properties often have no historical audited financial statements. New Rule 3-05(f) formally permits issuers to provide an audited statement of revenues and direct operating expenses (i.e., excluding corporate overhead, depreciation, depletion, amortization, income tax and interest expenses) instead of a full income statement and balance sheet, as long as certain conditions are met. This has been the SEC staff's practice for some time, but issuers were still required to submit a formal request similar to a no-action letter request. With the adoption of the final amendments, that step will no longer be necessary.

In addition, Rule 3-05(f) expressly requires issuers to include the FASB proved reserve and standardized measure disclosures[3] along with the non-industry specific historical target company financial statements.

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[1] For purposes of these tests, the issuer's financial metrics are generally calculated on a consolidated basis for the issuer and its consolidated subsidiaries, excluding the target company.

[2] Revenue is considered an important indicator of the operations of a business and generally has less variability than income from continuing operations, which can include expenses related to historical capitalization (e.g., interest expense) as well as certain other infrequent or nonrecurring expenses. Note that prior to 1981, the significance test included a revenue test, and the SEC eliminated the revenue test in favor of an income test because it considered that the presentation of additional financial disclosure for a target company may not be meaningful if, for example, the target company had high sales volumes but a relatively low profit margin.

[3] See FASB ASC Topic 932 *Extractive Activities – Oil and Gas* 932-235-50-3 through 50-11 and 932-235-50-29 through 50-36.