



## Securities Law ADVISORY ■

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### SEC Adopts Amendments to Regulation S-X to Improve Financial Disclosure

On May 21, 2020, the Securities and Exchange Commission adopted [amendments](#) to the financial disclosure requirements in Regulation S-X relating to the acquisition and disposition of businesses by registrants. The amendments, including Rule 3-05, Financial Statements of Businesses Acquired or to Be Acquired; Rule 3-14, Special Instructions for Real Estate Operations to Be Acquired; and Article 11, Pro Forma Financial Information, focus on the financial information required to be disclosed in connection with the acquisition and disposition of businesses, real estate operations, and investment companies. Registrants will not be required to apply the amendments until the beginning of the registrant's fiscal year beginning after December 31, 2020, with voluntary compliance permitted before then.

#### Significance Tests

Under Rule 3-05 of Regulation S-X, a registrant that acquires a significant business, other than a real estate operation, is generally required to provide separate audited annual and unaudited interim pre-acquisition financial statements of the business ("Rule 3-05 Financial Statements"). A business is deemed "significant" if it would be considered a "significant subsidiary" pursuant to any of the tests set forth under Rule 1-02(w): Investment Test, Income Test, or Asset Test. The amendments substantively revise the Investment Test and Income Test, with nonsubstantive changes made to the Asset Test. In addition, the amendments created a separate definition of "significant subsidiary" specifically for investment companies.

Note that Rule 3-05 provides for the use of a 20% significance threshold for determining when financial statements are required, rather than the 10% threshold for the tests indicated in Rule 1-02(w).

#### ***The Investment Test***

The existing Investment Test compares the registrant's investments in the target business to the registrant's total assets reflected at the end of the most recently completed fiscal year, or in the case of an acquired business, in the registrant's most recent annual financial statements required to be filed at or before the acquisition date.

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For acquisitions and dispositions, the revised Investment Test will compare the registrant's investment in the target business to the aggregate worldwide market value of the registrant's voting and nonvoting common equity. The amendments provide that the Investment Test is generally met when the registrant's and its other subsidiaries' investments in and advances to the tested subsidiary exceed 10% of the aggregate worldwide market value, of the registrant's voting and nonvoting common equity, or if the registrant has no such aggregate worldwide market value, the total assets of the registrant and its subsidiaries consolidated as of the end of the most recently completed fiscal year.

For combinations between entities or businesses under common control, this test is met when either the net book value of the target business exceeds 10% of the registrant's total assets or the number of common shares exchanged by the registrant exceeds 10% of its total common shares outstanding. The existing test will be retained when the registrant does not have an aggregate worldwide market value, and for purposes other than acquisitions and dispositions under Rule 1-02(w).

Registrants will use the average of aggregate worldwide market value calculated daily for the last five trading days of the registrant's most recently completed month ending before the earlier of the registrant's announcement date or agreement date of the acquisition or disposition. The "investment in" the target business shall include the fair value of contingent consideration if required to be recognized at fair value by the registrant at the acquisition date under U.S. generally accepted accounting principles (GAAP) or the International Financial Reporting Standards as issued by the International Accounting Standards Board (IFRS-IASB), as applicable; however, if recognition at fair value is not required, it shall include all contingent consideration, unless the likelihood of payment is remote.

### ***The Income Test***

The current Income Test is met when the pre-tax net income of the target business exceeds 10% of the registrant's pre-tax net income. The new Income Test adds a revenue component in which the target business's annual revenue from continuing operations (after intercompany eliminations) must also exceed 10% of the registrant's consolidated annual revenue for the most recently completed fiscal year. To be deemed significant under the amended Income Test, the tested business must meet both the revenue component and the net income component when the revenue component applies, and for purposes of the application of Rule 3-05, may use the lower of the revenue component and the net income component to determine the number of periods for which Rule 3-05 Financial Statements are required. The revenue component does not apply if either the registrant or the relevant business did not have material revenue in each of the two most recently completed fiscal years. Modifying the original proposal to use net income after taxes, the new Income Test continues to use the pre-tax net income for its calculations. The amendments also revise income-averaging calculations and the use of absolute values, as well as additional clarifications and simplifications.

### ***The Asset Test***

The Asset Test is met when the registrant's proportionate share of the target's total assets exceeds 10% of the total assets of the registrant. When computing the Asset Test for acquisitions, intercompany transactions with the acquired business must be eliminated from the registrant's and its subsidiaries' consolidated total assets.

## Change in Years of Financial Statements for Acquisitions

Rule 3-05 will now only require up to two years of financial statements, as opposed to up to three years previously. Additionally, for acquisitions whose significance test exceeds 20%, but not 40%, the amendments revise the interim financial statement requirement to only require interim financial statements for the “most recent” interim period specified in Rules 3-01 and 3-02 rather than “any” interim period, which eliminates the need to provide a comparative interim period when only one year of audited Rule 3-05 Financial Statements is required. However, regardless of the number of years presented, if trends depicted in Rule 3-05 Financial Statements are not indicative of the current financial condition or are otherwise incomplete, Rule 4-01(a) requires that a registrant provide “such further material information as is necessary to make the required statements, in light of the circumstances under which they are made, not misleading.”

## Disclosure Requirement for Individually Insignificant Acquisitions

Rule 3-05(b)(2)(iv) is amended to only require audited historical pre-acquisition financial statements in a registration statement or proxy statement if the target has over 20% significance.

Additionally, registrants must now provide pro forma financial information depicting the aggregate effects of all individually insignificant businesses in all material respects if the aggregate impact of businesses acquired or to be acquired since the date of the most recent audited balance sheet filed for the registrant, for which financial statements are either not otherwise required or are not yet required, exceeds 50% for any condition. The amendments also clarify that “individually insignificant businesses” include:

- Any acquisition consummated after the registrant’s audited balance sheet date whose significance is 20% or lower.
- Any probable acquisition whose significance is 50% or lower.
- Any consummated acquisition whose significance is between 20% and 50% and whose financial statements are not yet required by Rule 3-05(b)(4) because of the 75-day filing period.

Registrants must include both Rule 3-05 businesses and Rule 3-14 real estate operations when determining the aggregate impact of the Investment Test for individually insignificant acquisitions.

## Disclosure Requirement for Acquisitions of a Component of an Entity

Rule 3-05(e) is amended to permit registrants to provide abbreviated audited financial statements in the form of statements of assets acquired and liabilities assumed, and statements of revenues and expenses if the target meets certain qualifying and presentation conditions:

Qualifying conditions:

- The total assets and total revenues of the target constitute 20% or less of the corresponding amounts of the seller as of and for the most recently completed fiscal year.
- The target was not a separate entity, subsidiary, operating segment, or division during the periods for which the target financial statements would be required.

- Separate financial statements for the business have not previously been prepared.
- 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.

Although the 20% threshold in the first qualifying condition differs from the original proposal, the adopting release noted that this threshold is generally consistent with the staff's granting of relief pursuant to Rule 3-13 and, in situations where an acquired business exceeds the 20% threshold but the registrant nonetheless confronts unique challenges in making the relevant allocations necessary to provide Rule 3-05 Financial Statements, the registrant could continue to seek relief pursuant to Rule 3-13.

Presentation conditions:

- The balance sheet may be a statement of assets acquired and liabilities assumed.
- The statement of comprehensive income may be a statement of revenues and expenses (exclusive of corporate overhead, interest, and income tax expenses) if certain presentation requirements are met and the title of the statement of comprehensive income is appropriately modified to indicate it omits certain expenses.
- The statement of comprehensive income must include expenses incurred by or on behalf of the target during the pre-acquisition financial statement periods to be presented, including costs of sales or services, selling, distribution, marketing, general and administrative, depreciation and amortization, and research and development, but may otherwise omit corporate overhead expenses.
- Interest expense may be excluded from the statements if the interest expense debt will not be assumed by the registrant.
- Income tax expense may be omitted.
- The notes to the financial statements include the following additional disclosures:
  - The type of omitted expenses and the reasons why they are excluded from the financial statements.
  - An explanation of the impracticability of preparing financial statements that include the omitted expenses.
  - A description of how the financial statements presented are not indicative of the financial condition or results of operations of the target going forward because of the omitted expenses.
  - Information about the business's operating, investing, and financing cash flows, to the extent available.

### **Permit the Use of IFRS-IASB for Foreign Businesses and Foreign Private Issuers**

Rule 3-05(c) is amended to permit foreign private issuers that prepare their financial statements using IFRS-IASB to reconcile Rule 3-05 Financial Statements of foreign businesses prepared using home country GAAP to IFRS-IASB instead of U.S. GAAP. Additionally, the amendments permit 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 as a foreign private issuer if it were a registrant.

## Omit Rule 3-05 Financial Statements for Businesses That Have Been Included in Registrants' Financial Statements

Rule 3-05 Financial Statements no longer need to be included in registration statements and proxy statements for businesses once the target is reflected in filed post-acquisition registrant financial statements for a certain period of time:

- For businesses between 20% and 40% significance, the period is nine months.
- For businesses with greater than 40% significance, the period is a complete fiscal year.

## Rule 3-14 Real Estate Operations

Under Rule 3-14 of Regulation S-X, a registrant that has acquired, or proposes to acquire, a significant real estate operation must file separate audited annual and unaudited interim abbreviated income statements for that operation. Although not previously defined under Rule 3-14, the amendments define a real estate operation as "a business that generates substantially all of its revenues through the leasing of real property."

### *Aligning Rule 3-14 with Rule 3-05*

Rule 3-14 is revised to be aligned with Rule 3-05 when no significant industry considerations exist. Among other amendments, the Rule 3-14 significance thresholds for individual acquisitions has been changed to 20%, and the significance threshold for the aggregate impact of acquisitions has been changed to 50%. The application of Rule 3-14 has also been aligned with Rule 3-05 by revising Rule 3-06 to allow financial statements that cover a nine-month to 12-month period to satisfy the requirement to provide one year of financial statements of acquired or to-be-acquired real estate operations.

The filing period for filing Rule 3-14 financial statements in registration statements and proxy statements will also be aligned with Rule 3-05, and Rule 3-14 financial statements will no longer be required in registration statements and financial statements once the acquired real estate operation is reflected in the registrant's filed post-acquisition financial statements for nine months. The amendments also eliminate the specific requirement to provide three years of financial statements for acquisitions from related parties. Lastly, the amendments conform the formatting and language of Rule 3-14 to Rule 3-05.

### *Clarifying the Application of Rule 3-14*

To clarify certain ambiguous provisions of Rule 3-14 and its requirements, amendments were made to the following topics of the rule:

**Significance Test** – Rule 3-14(b)(2) is amended to require the use of the Investment Test in Rule 1-02(w). When the test is based on total assets (as opposed to worldwide market value), the test should be adapted so that the registrant's and its subsidiaries' investment in the real property includes any debt secured by the real property that is assumed by the registrant.

**Interim financial statements** – There is currently no express requirement for registrants to provide interim financial statements under Rule 3-14; however, because of the requirements in Article 11 and related staff interpretations, existing practice is to provide interim financial statements for acquisitions of real estate operations. The amendments to Rule 3-14 codify existing practice and require Rule 3-14 financial statements for the most recent year-to-date interim period before the acquisition.

**Blind pool real estate offerings** – Registrants in blind pool offerings typically apply an adapted significance test when making the determination of whether to provide Rule 3-14 Financial Statements. Under the new amendments, significance tests during the distribution period are computed by comparing the registrant's and its subsidiaries' investment in the real estate operation to the sum of (1) the registrant's total assets as of the acquisition date; and (2) the proceeds (net of commissions) in good faith expected to be raised in the registered offering over the next 12 months. The amendments also extend this adapted significance test to Rule 3-05 acquisitions by registrants in blind pool offerings.

## **Adjustments to Pro Forma Financial Information Requirements**

Registrants that must file separate financial statements under Rule 3-05 or Rule 3-14 must also file unaudited pro forma financial information under Article 11 of Regulation S-X.

Rule 11-02(a), which described the objectives of the preparation requirements, has been deleted. In addition, the pro forma adjustment criteria in Article 11 are replaced with simplified adjustment criteria that are broken out into:

- "Transaction Accounting Adjustments" that will reflect only the application of required accounting to the transaction.
- "Autonomous Entity Adjustments" that will reflect the financials and operations of the registrant as an autonomous entity when the registrant was previously part of another entity.
- "Management's Adjustments" that will provide flexibility for registrants to include forward-looking information that depicts synergies and dis-synergies management has identified.

The Transaction Accounting Adjustments and Autonomous Entity Adjustments are required. Management's Adjustments are optional, but the conditions set forth in Rule 11-02(a)(7)(i), Basis for Management's Adjustments, and Rule 11-02(a)(7)(ii), Form of Presentation, must be satisfied in order for registrants to present Management's Adjustments.

## **Significance for Business Dispositions**

The amendments include changes to Article 11 and Item 2.01 of Form 8-K to (1) raise the significance threshold for the disposition of a business from 10% to 20% to conform to the threshold at which an acquired business is significant under Rule 3-05; and (2) conform the tests used to determine the significance of a disposed business to those used to determine the significance of an acquired business.

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

The amendments to the financial statement requirements of smaller reporting companies are adopted substantially as proposed. Rule 8-04 requirements to provide financial statements of businesses acquired or to be acquired have been revised to refer to Rule 3-05, except form and content requirements. The amendments also permit smaller reporting companies and issuers relying on Regulation A to omit historical financial statements of acquired businesses if the business has been included in the registrant's results for either nine months or a completed fiscal year, depending on significance.

Smaller reporting companies are eligible to exclude from registration statements the financial statements for businesses that were acquired no more than 74 days before the date of the relevant final prospectus or prospectus supplement, rather than 74 days before the effective registration statement. Also, Rule 8-01 is amended to expressly permit application of Rule 3-06 to the preparation of financial statements of smaller reporting companies and issuers relying on Regulation A.

Form 8-K and Article 8 were also amended to require smaller reporting companies to provide pro forma financial information for disposition of a significant business in Form 8-K and in certain registration statements and proxy statements when the disposition occurs during or after the most recently completed fiscal year.

## **New Rule 6-11 and Changes to Form N-14**

A new Rule 6-11 creates specific rules or requirements for the financial statements of investment companies' acquired funds and supplemental financial information related to such acquisitions to be provided in lieu of pro forma financial disclosures. Instead of applying the general requirements of Rule 3-05 that are not well suited for investment companies, Rule 6-11 creates new financial disclosure obligations for the acquired funds of investment companies. Accordingly, the disclosure requirements of Form N-14 are being amended substantially as proposed for consistency with the disclosures required in new Rule 6-11.

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