SEC Proposes "Registrant Friendly" Changes to Reporting Requirements for Acquired and Disposed Businesses

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On May 3, 2019, the SEC issued a proposed rule[1] that would amend the financial statement requirements for acquisitions and dispositions of businesses, including real estate operations, and related pro forma financial information. These changes are intended to improve the information investors receive regarding acquired or disposed businesses, reduce complexity and costs of preparing the required disclosures, and facilitate timely access to capital.

INTRODUCTION

The proposed amendments include changes to improve the disclosure requirements for: (1) acquired or to be acquired businesses in SEC Regulation S-X, Rule 3-05;[2] (2) real estate operations in SEC Regulation S-X, Rule 3-14;[3] and (3) pro forma financial information in SEC Regulation S X, Article 11,[4] as well as modifications to the significance tests in SEC Regulation S-X, Rule 1-02(w).[5] In addition, the proposed rule includes amendments to financial disclosures specific to smaller reporting companies[6] (SRCs) and investment companies.[7]

KEY PROVISIONS

Rule 3-05 requires registrants, including entities undertaking an initial public offering (IPO), to file the separate preacquisition/disposition financial statements for a significant acquired/disposed or to be acquired/disposed business. Similarly, Rule 3-14 requires a registrant to provide preacquisition financial statements for a significant acquired or to be acquired real estate operation (real estate acquiree). The number of periods of the acquiree's or disposal business results that are required to be filed are based on the significance levels determined after performing the applicable significance tests in Rule 1-02(w) (i.e., the investment, asset, and income tests). Further, Article 11 requires a registrant to provide pro forma financial information depicting the impact of a significant acquisition or disposition. These pro forma disclosures can be important to investors because they provide insights into the effects of an acquisition or disposition on a registrant's financial condition, results of operations, liquidity, and future prospects.

Key items in the proposed amendment include:

- Change the investment test to use aggregate worldwide market value of common equity of the registrant calculated as of the last day of the most recently completed fiscal year in the denominator in place of the book value of the registrant's total assets.
- A registrant would need to meet the minimum significance tests for **BOTH** the net income (previously pretax income) test and a new revenue test to be considered significant. If only one of the tests is met, then the acquisition or disposition is not considered significant. If both tests are met, then of the two tests, the test result that provides the lowest ratio is used to determine the number of years of financial statements to present.
- Reduce the required acquiree annual financial statement periods to a maximum of the two most recent fiscal years.
- Permit use of abbreviated financial statements for an acquiree in certain circumstances without having to request SEC staff permission.
- Allow the use of, or reconciliation to, IFRS as issued by the International Accounting Standards Board (IASB) in certain circumstances.
- Amend the pro forma financial information disclosures to require adjustments and certain disclosures for: (1) "Transaction Accounting Adjustments" and (2) "Management's Adjustments" (e.g., reasonably estimable synergies and other impacts of the acquisition).
- Align certain requirements for a real estate acquiree with those in Rule 3-05.

- Raise the significance threshold for reporting dispositions of a business from 10 percent to 20 percent to conform the threshold with that for a significant acquisition.
- Make other changes specific to Smaller Reporting Companies ("SRCs") and investment companies.
- A consequence of the amendment is it will result in fewer circumstances requiring acquiree financial statements for an IPO and for individually insignificant acquires.

FTI CONSULTING'S KEY TAKEAWAYS

- Although the proposed amendments reduce the number of periods of the acquiree's results required under Rule 3-05 (e.g., by eliminating the third year of acquiree financial statements), the proposal does not extend to financial statements of: (1) target companies included in a proxy statement or registration statement on Form S-4 or (2) a company that is considered the predecessor[8] of a registrant.
- The significance tests outlined in Rule 1-02(w) are used throughout the SEC's disclosure requirements and regulations, and the proposed rule would retain the consistent application of the significance tests. Thus, the changes described above would also apply when a registrant is evaluating equity method investments for significance to determine the financial statements or financial information required in accordance with SEC Regulation S-X, Rule 3-09,[9] or SEC Regulation S-X, Rule 4-08(g).[10]
- The proposed rule clarifies that the operations of the acquiree would need to be reflected in the audited financial statements of the registrant for a complete fiscal year, or all 12 months of the registrant's most recently completed fiscal year, before separate financial statements for the acquiree are no longer required. SEC Regulation S-X, Rule 3-06,[11] which permits the filing of financial statements for a period of nine to 12 months to satisfy a one-year requirement, could not be applied by analogy. Further, the 12-month requirement could not be reduced by preacquisition historical financial statements that may be provided, as is currently contemplated in the Division of Corporation Finance's Financial Reporting Manual (FRM).
- Although the proposed rule would eliminate the requirement to provide separate financial statements for any individually insignificant acquirees, a registrant would still be required to obtain sufficient historical financial information about all of its individually insignificant acquirees to prepare the required pro forma financial information. In addition, if that information is derived from financial records that have not been subject to audit or review procedures, it may affect the level of comfort that could be provided to underwriters by auditors in conjunction with a securities offering.
- Although the proposed rule would increase the instances in which a registrant may provide financial statements of a foreign acquiree prepared in accordance with IFRS without reconciliation to U.S. GAAP, the pro forma financial information reflecting the acquiree must nonetheless be presented in accordance with the basis of presentation of the registrant. That is, a registrant that prepares its financial statements in accordance with U.S. GAAP and presents IFRS financial statements for a foreign acquiree must obtain sufficient historical financial information about the acquiree under U.S. GAAP to comply with the pro forma requirements of the registrant.
- Under the existing requirements, adjustments that reflect synergies or other actions taken or expected to be taken by management generally do not qualify as pro forma adjustments because they do not meet the "factually supportable" or "directly attributable" criteria. Under the proposed rule, Management's Adjustments, which may include forward-looking information,[12] would be required. This may affect the level of comfort that could be provided to underwriters by auditors in conjunction with a securities offering.
- The proposed change to the investment test will benefit some companies (primarily those without a significant amount of borrowings and/or those for which the drivers of the value of the common stock are not reflected as assets, because of the accounting for research & development ("R&D") costs, but will adversely impact others (primarily those who are heavily leveraged.

REAL ESTATE OPERATIONS

The proposed rule includes several changes to substantially align Rule 3-14 with Rule 3-05 in an effort to reduce complexity while retaining certain industry-specific disclosures. The proposed rule also includes several changes to Rule 3-14, many of which codify positions that the SEC staff has historically applied and that were standard industry practice.

SMALLER REPORTING COMPANIES

The proposed rule includes corresponding changes to the requirements for SRCs. Although SEC Regulation S-X, Article 8,[13] currently requires financial statements and pro forma financial information for acquirees, it does not provide the same level of detailed guidance as Rule 3-05 and Article 11. Although SRCs could continue to prepare acquiree financial statements in accordance with Article 8 (e.g., the form and content requirements), the proposed rule would specifically refer to the requirements in Rules 3-05 and 3-14 for other requirements. Similar changes were proposed for pro forma financial information, which would refer to Article 11 for the presentation and disclosure requirements (except for the condensed format allowed for SRCs). Given the alignment with Article 11, the proposed rule would result in changes to the types of adjustments to be made, in addition to the changes proposed to Rule 3-05 that may affect the number of periods to be presented.

INVESTMENT COMPANIES

Under current regulations, investment companies follow the same general requirements of Rule 3-05 and Article 11 as do other registrants. However, because of the unique characteristics of investment companies, it is often unclear how to apply these rules.

The proposed rule would also add SEC Regulation S X, Rule 6-11,[14] and Rule 1-02(w)(2), which, among other things, provide investment company-specific significance tests: (1) the investment test, which would focus on the value of the total investments, and (2) the income test, which would use measures commonly included in the investment company's financial statements, such as changes in net assets from operations.[15] In addition, the proposed rule would: (1) make certain revisions to the significance thresholds that may reduce the need to provide financial statements, and (2) limit the audited financial statement periods required for an acquired fund to one year and the most recent unaudited interim period.

HOW FTI CAN HELP

FTI Consulting professionals are prepared to help you understand and navigate these rule changes, including in the following areas:

- Assist in analyzing the application of these rules for filings and the preparation of preclearance letters with the SEC
- Assist in the preparation of Rule 3-05 financial statements
- Facilitate audit processes for targets that had not previously been audited (i.e., carve outs, private companies)

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FOOTNOTES

[1] SEC Proposed Rule Release No. 33-10635, "Amendments to Financial Disclosures About Acquired and Disposed Businesses". Public comments on the proposed amendments are due July 29, 2019, and can be submitted online via https://www.sec.gov/cgi-bin/ruling-comments by referencing S7-05-19.

[2] SEC Regulation S-X, Rule 3-05, "Financial Statements of Businesses Acquired or to Be Acquired."

[3] SEC Regulation S-X, Rule 3-14, "Special Instructions for Real Estate Operations to Be Acquired."

[4] SEC Regulation S-X, Article 11, "Pro Forma Financial Information."

[5] SEC Regulation S-X, Rule 1-02(w), "Definitions of Terms Used in Regulation S-X: Significant Subsidiary."

[6] SRCs, as defined in SEC Regulation S-K, Item 10(f)(1), "General: Smaller Reporting Companies," and issuers relying on SEC Regulation A (collectively referred to as SRCs).

[7] Investment companies registered under the Investment Company Act and business development companies (collectively referred to as investment companies).

[8] See paragraph 1170.1 of the SEC Financial Reporting Manual (FRM).

[9] SEC Regulation S-X, Rule 3-09, "Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons."

[10] SEC Regulation S-X, Rule 4-08(g), "General Notes to Financial Statements: Summarized Financial Information of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons."

[11] SEC Regulation S-X, Rule 3-06, "Financial Statements Covering a Period of Nine to Twelve Months."

[12] The proposed rule would revise Article 11 so that any forward-looking information supplied is expressly covered by the safe harbor rule.

[13] SEC Regulation S-X, Article 8, "Financial Statements of Smaller Reporting Companies."

[14] SEC Regulation S-X, Rule 6-11, "Financial Statements of Funds Acquired or to Be Acquired."

[15] The proposed rule refers to including, for example, any net realized gains and losses and net change in unrealized gains and losses.

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