SEC ADOPTS AMENDMENTS REGARDING FINANCIAL DISCLOSURES ABOUT ACQUISITIONS AND DISPOSITIONS OF BUSINESSES

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Legal Briefings – By **Dinesh Banani, Tom O'Neill and Sara Canby**

On 21 May 2020, the U.S. Securities and Exchange Commission (the "SEC") announced the adoption of amendments to its requirements for the disclosure of financial statements relating to acquisitions and dispositions of businesses, including disclosure of related pro forma financial information. The amendments are part of the SEC's ongoing evaluation of its disclosure rules and provide a comprehensive update and streamlining to the acquired business financial disclosure requirements, some of which have been in place for over 30 years. In practice, the amendments should reduce the complexity and costs of preparing such disclosure.

The amendments are relevant for SEC-registered initial public offerings, as well as existing SEC registrants (including foreign private issuers with U.S. reporting obligations) and foreign private issuers that are contemplating offerings of securities in reliance on Rule 144A under the U.S. Securities Act of 1933 (the "Securities Act"), where U.S. execution and disclosure standards will often apply by analogy as a matter of market practice.

The amendments will be effective on 1 January 2021, but voluntary compliance will be permitted in advance of the effective date. The SEC's 21 May 2020 announcement regarding the amendments can be found here and the final rules are available here.

CURRENT RULES

The amendments relate primarily to Rule 3-05 and Article 11 of Regulation S-X under the Securities Act, in addition to other rules and forms relating to financial disclosures about acquisitions and dispositions of businesses.

Rule 3-05 of Regulation S-X requires an issuer to provide separate audited annual and unaudited interim pre-acquisition financial statements of an acquired business ("Rule 3-05 Financial Statements") for varying periods, depending on the "significance" of the acquired business relative to the issuer. The significance of a completed or "probable" acquisition is assessed under the highly technical investment, asset and income tests (together, the "significance tests"), which are generally calculated by the issuer's auditors and expressed as a percentage. A completed or "probable" acquisition is "significant" if it meets the 20% threshold on any of the significance tests.

Subject to certain exceptions, Rule 3-05 Financial Statements are required for a completed acquisition between the 20% and 50% significance levels if completion occurred at least 75 days prior to the date of the offering document (i.e., outside of the "75-day grace period"); Rule 3-05 Financial Statements will generally be required for a completed or "probable" acquisition meeting the 50% threshold under any of the significance tests and the 75-day grace period is not available to such acquisitions.

Article 11 of Regulation S-X requires an issuer that is required to provide Rule 3-05 Financial Statements to also provide unaudited pro forma financial information relating to an acquisition or disposition[1]. Pro forma financial information typically includes a pro forma balance sheet and pro forma income statements based on the historical financial statements of the issuer and the acquired or disposed business, including adjustments to show how the acquisition or disposition might have affected those financial statements.

AMENDMENTS

The SEC summarized the amendments[2], stating they will:

- update the significance tests by:
    - revising the investment significance test to compare (i) the issuer's investments in and advances to the acquired or disposed business to (ii) the issuer's aggregate

worldwide market value if available (instead of total assets, which are measured at book value);

    - revising the income significance test by adding a revenue component to the net income component;

    - expanding the use of pro forma financial information in measuring significance; and

    - conforming, to the extent applicable, the significance threshold and tests for disposed businesses to those used for acquired businesses;

- modify and enhance the required disclosure for the aggregate effect of acquisitions for which financial statements are not required or are not yet required by eliminating historical financial statements for insignificant businesses and expanding the pro forma financial information to depict the aggregate effect in all material respects;

- require Rule 3-05 Financial Statements to cover no more than the two most recent fiscal years, noting that if trends depicted in Rule 3-05 Financial Statements are not indicative or are otherwise incomplete, an issuer must 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";

- permit abbreviated disclosure of financial statements that omit certain expenses for certain acquisitions of a component of an entity, which is particularly helpful in circumstances where the acquired business represents only a small portion of the selling entity and thus does not maintain separate and distinct accounts necessary to prepare Rule 3-05 Financial Statements;

- permit the use of, or reconciliation to, International Financial Reporting Standards as issued by the International Accounting Standards Board ("IFRS-IASB") rather than U.S. GAAP in certain circumstances, in order to increase the consistency between the basis of accounting used by acquired businesses and foreign private issuers, as well as to permit acquired businesses and issuers to avoid unnecessary costs (as discussed in further detail below);

- make Rule 3-05 more consistent with Rule 3-06 by permitting omission of separate acquired business financial statements in a broader range of circumstances once the acquired business has been included in the issuer's post-acquisition financial statements for nine months or a complete fiscal year, depending on significance;

- amend the pro forma financial information requirements to improve the content and relevance of such information; more specifically, the revised pro forma adjustment criteria will provide for:

- mandatory “Transaction Accounting Adjustments” reflecting (i) in the pro forma condensed balance sheet the accounting for the transaction required by U.S. GAAP or IFRS-IASB, as applicable, and (ii) in the pro forma condensed income statements, the effects of those pro forma balance sheet adjustments assuming the adjustments were made as of the beginning of the fiscal year presented;

- mandatory “Autonomous Entity Adjustments” reflecting the operations and financial position of the issuer as an autonomous entity if the issuer was previously part of another entity; and

- optional “Management’s Adjustments” including forward-looking information that depicts synergies and dis-synergies of the acquisitions and dispositions for which pro forma effect is being given if, in management’s opinion, such adjustments would enhance an understanding of the pro forma effects of the transaction and certain conditions related to the basis and the form of presentation are met.

It will be interesting to see how many issuers decide to include “Management’s Adjustments” in their pro forma financial information. In its adopting release for the new rules, the SEC observed that most of the public comments on pro forma financial information focused on such “Management’s Adjustments” and public feedback was very mixed. The SEC acknowledged that such adjustments “may not be appropriate for all circumstances” and noted that any forward-looking information supplied in “Management’s Adjustments” is expressly covered by existing safe harbour provisions for forward-looking information set forth in Rule 175 under the Securities Act and Rule 3b-6 under the U.S. Securities Exchange Act of 1934 (the “Exchange Act”).

MORE LIBERALISED USE OF IFRS-IASB

The amendments address the mismatch between the definition of “foreign private issuer” and the more stringent “foreign business” definition used in Rule 3-05, which had previously resulted in circumstances where an acquired business that did not meet the definition of foreign business (but was otherwise permitted to present its financial statements using IFRS-IASB as a foreign private issuer under Regulation S-X) would be required to have its Rule 3-05 Financial Statements prepared in accordance with U.S. GAAP at significant cost to the issuer. The SEC noted the need to permit issuers to avoid unnecessary costs such as “one-time presentations of the U.S. GAAP reconciling information where such information would not be material to investors.” Thus, the amendments 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 rather than U.S. GAAP in order to “provide more comparable information and better facilitate analysis of the financial statements” as well as to follow the form and content requirements of Form 20-F. In addition, 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 as a foreign private issuer if it were an SEC registrant.[3]

LIKELY IMPACT ON RULE 144A PRACTICE

Although Rule 3-05 and Article 11 of Regulation S-X and related rules are not technically applicable to unregistered offerings conducted under Rule 144A, the application of such rules is important in the context of ensuring that a Rule 144A offering document that is subject to "Rule 10b-5 execution standards" does not contain any material misstatements or omissions.

For Rule 144A offerings, the amendments should make it easier to apply the significance definition and reduce the likelihood of anomalous results under the significance tests, which was a major complaint under the previous rules. For example, the amendments to the investment significance test requiring use of the issuer's aggregate worldwide market value rather than the historical book value of its total assets to assess significance should better reflect the relative size of the acquired business in economic terms. The addition of a revenue component to the income significance test should mitigate the effect of infrequent expenses, gains, and losses on the calculation and also potentially prevent insignificant businesses from being deemed significant for issuers with marginal or break-even net income or loss. Many of the amendments should also reduce the volume of information presented about acquired businesses and focus the disclosures on more decision-relevant information.

As a result, these amendments are likely to help quicken the execution process for a Rule 144A offering conducted in connection with, or on or around the time of, an M&A transaction by the issuer. In the adopting release for the amendments, the SEC observed that an issuer's ability to provide disclosure for periods prior to an acquisition is often dependent on access to and the cooperation of both the acquired business and its independent auditor. The age of the acquired business's required financial statements, as well as changes in the acquired business's personnel or its independent auditor that occurred during the historical periods for which financial statements may be required, can impair an issuer's ability to timely meet the financial reporting requirements for such acquisitions; this may adversely impact the issuer's ability to access capital within the time frames it needs to operate its business and make investments. The amendments should help to ameliorate these impediments to capital formation by focusing on more recent historical periods, relying on more relevant disclosure triggers and definitions, and increasing the relevance of pro forma financial information.

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1. Please note that marketing and/or disclosure considerations may lead to the inclusion of Rule 3-05 Financial Statements and related pro forma financial information in offering documents even when not strictly required under Rule 3-05.

2. Please note that amendments relating to oil and gas producing businesses, real estate operations and investment companies have been omitted for purposes of this summary.

3. Given the SEC's focus on comparability for investors, in circumstances where an SEC registrant presents its financial statements in U.S. GAAP, the pro forma financial information reflecting the acquisition will continue to be required to be presented in U.S.

GAAP.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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