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Corporate & Securities CLIENT BULLETIN

June 2020

ALERT: SEC Adopts Amendments to Financial Disclosures about Acquired and Disposed Businesses

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In May 2020, the Securities and Exchange Commission (the "SEC") adopted amendments to rules regarding, among other changes, the determination of whether a subsidiary or an acquired or disposed business is significant and the disclosure requirements for financial statements in connection with the acquisition or disposition of a business.

This Alert summarizes certain of the key changes adopted by the SEC relevant to public reporting companies engaging in M&A transactions.

As a reminder, this Advisory is being sent to draw your attention to issues and is not to replace legal counseling.

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Updates to the Significance Tests

When a reporting company acquires a business that is deemed "significant" under Regulation S-X, this triggers a requirement that the acquiring reporting company provide separate audited annual and unaudited interim pre-acquisition financial statements of that acquired business. The number of years of financial information that must be provided depends on the magnitude of the significance of the acquisition to the acquirer. Reporting company acquirers are also required to file unaudited pro forma financial information relating to significant acquisitions or dispositions (see below for a discussion of pro forma financial information requirements).

The amendments, among other things, update the tests used to determine "significance"[1]:

Existing Test		Amended Test
Investment Test	Amount of acquirer's investments in/advancements to the target *compared to* acquirer's **total assets**	Amount of acquirer's investments in/advancements to the target *compared to* acquirer's **aggregate worldwide market value**[2]
Asset Test	Target's total assets *compared to* acquirer's total assets	*No substantive changes made to the asset test except to clarify that intercompany transactions with the acquired business are excluded from the acquirer's total assets amount*
Income Test	Target's income from continuing operations before income taxes, extraordinary items and cumulative effect of a change in accounting principles ("pre-tax income") *compared to* the pretax income of the acquirer for its most recent full fiscal year	The existing test **and Target's total revenue**[3] **compared to acquirer's total revenue**[4]

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Updates to Financial Statement Disclosure Requirements

The number of years of financial information required to be provided in the event of a significant acquisition depends on the magnitude of the significance. The amendments provide that public company acquirers will be required to provide financial statements of the acquired business for no more than the two most recent fiscal years (versus up to the three most recent fiscal years under the existing rules), as shown below:

Significance Threshold	Periods for Required Financial Statements
Greater than 20% but less than/equal to 40%	Most recent fiscal year financials **(audited)** and any interim period financials **(unaudited)**[5]
Greater than 40% ~~but equal or less than 50%~~	Two most recent fiscal years' financials **(audited)** and any interim period financials **(unaudited)**
~~**Greater than** 50%~~	~~Three most recent fiscal years' financials (audited) and any interim period financials (unaudited)~~

It should be noted that the acquisition of a series of individually insignificant businesses may result in a requirement to include acquired business financial statements in a registration statement or proxy statement in connection with an offering. Further, transactions requiring shareholder vote or involving securities offerings to holders of the target business may be subject to additional financial statement disclosure requirements in connection with such shareholder action.

Changes to Pro Forma Financial Information Requirements

In addition, Regulation S-X also requires reporting companies to file unaudited pro forma financial information relating to significant acquisitions or dispositions, and provides rules and instructions on the presentation of such information. Specifically, pro forma financial information typically includes a pro forma balance sheet and pro forma income statements based on the historical financial statements of the reporting company and the acquired or disposed business, including adjustments to show how the acquisition or disposition might have affected those financial statements. The pro forma financial information is supposed to show the impact of the transaction on income from continuing operations of the reporting company.

Regulation S-X provides that the only adjustments that are appropriate in the presentation of the pro forma condensed statement of comprehensive income are those that are:

- Directly attributable to the transaction;
- Expected to have a continuing impact on the registrant; and
- Factually supportable.

The pro forma condensed 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 financial position of the reporting company as of the balance sheet date.

The amendments to the pro forma financial information requirements are intended to improve the content and relevance of such information; more specifically, the amendments replace the existing pro forma adjustment criteria under Regulation S-X with simplified requirements to depict the accounting for the transaction.

The revised pro forma adjustment criteria will provide for:

- "Transaction Accounting Adjustments" reflecting only the application of required accounting to the transaction;
- "Autonomous Entity Adjustments" reflecting the operations and financial position of the registrant as an autonomous entity if the registrant was previously part of another entity; and
- Optional "Management's Adjustments" depicting 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.

Abbreviated Financial Statements for Assets that Constitute a Business

The SEC also adopted amendments meant to codify certain exemptive relief the SEC has previously provided on an ad hoc basis when reporting companies have acquired components of an entity that constituted a "business" but was not a separate entity, subsidiary, or division of the seller. As such businesses frequently do not have separate financial statements, or even separate or distinct accounts, providing the financial statements described above can be time-consuming and expensive, if not entirely impracticable. The amendments allow reporting companies to provide audited annual and unaudited interim abbreviated financial statements as follows:

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Conditions:

- The total assets and total revenues (both after intercompany eliminations) of the acquired or to be acquired business constitute 20% or less of such corresponding amounts of the seller and its subsidiaries consolidated as of and for the most recently completed fiscal year;
- The acquired business was not a separate entity, subsidiary, operating segment (as defined in U.S. GAAP or IFRS-IASB, as applicable), or division during the periods for which the acquired business financial statements would be required;
- Separate financial statements for the business have not previously been prepared; and
- 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.

Presentation Requirements:

- 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 must be appropriately modified to indicate it omits certain expenses);
- The statement of comprehensive income must include expenses incurred by or on behalf of the acquired business during the pre-acquisition financial statement periods to be presented including, but not limited to, 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; and
- Interest expense may be excluded from the statements if the debt to which the interest expense relates will not be assumed by the registrant or its subsidiaries consolidated;
- Income tax expense may be omitted; and
- The notes to the financial statements include the following additional disclosures:
  - (i) The type of omitted expenses and the reason(s) why they are excluded from the financial statements;
  - (ii) An explanation of the impracticability of preparing financial statements that include the omitted expenses;
  - (III) A description of how the financial statements presented are not indicative of the financial condition or results of operations of the acquired business going forward because of the omitted expenses; and
  - (iv) Information about the business's operating, investing and financing cash flows, to the extent available.

Revisions to Disposition Threshold

Regulation S-X also requires the provision of pro forma financial information in connection with the disposition of a significant portion of a business through a sale, abandonment, or distribution to shareholders. Under the existing rules, as discussed above, an acquisition is deemed significant if it met the 20% threshold under the investment, asset, or income test. However, under the existing rules, a disposition is deemed significant if it meets a 10% threshold under those tests. The amendment increased the threshold for significant dispositions to 20%, to align with the acquisition significance threshold.

Effective Date

The amendments are effective January 1, 2021, however, voluntarily compliance is permitted prior to the effective date (provided that the company applies the new rules going forward).

If you have any questions regarding the above, please contact a member of Benesch's Corporate & Securities Practice Group.

[1] These tests are also used by public companies to determine the significance of subsidiaries.

[2] "Aggregate worldwide market value" is determined by using the average of such aggregate worldwide market value calculated daily for the last five trading days of the reporting company acquirer's most recently completed month ending prior to the earlier of the announcement date or agreement date of the acquisition or disposition. Where a company does not have an aggregate worldwide market value, the existing test (total assets of the acquirer) will be used.

[3] The revenue test is not available if either the acquirer or target did not have material revenue in each of the two most recently completed fiscal years.

[4] When applying the amended income test:

- For determining significance, the tested business must meet both the revenue component and the net income component (when the revenue component applies).
- For determining the number of periods for which financial statements are required, the **lower** of the revenue component and the net income component is used.

[5] Corresponding prior year interim period financial statements not required.