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SEC Issues Final Amendments to Reporting Requirements for Acquired and Disposed Businesses

In May 2019, the Securities and Exchange Commission (“SEC”) proposed changes to reporting for acquisitions and dispositions by registrants. The proposed amendments resulted from an ongoing, comprehensive evaluation of the existing disclosure requirements and concerns that they were overly cumbersome and slowed access to the capital markets. In May 2020, the SEC issued the final amendments substantially as originally proposed with some changes and clarifications.

Introduction

The amendments should be welcomed by acquisitive registrants as these changes will likely reduce the number of acquisitions deemed significant as well as reduce the amount of required financial information for significant acquisitions.

Key Provisions

Under SEC Rule 3-05, a registrant that acquires a business is generally required to provide separate audited annual and unaudited interim pre-acquisition financial statements of the business if it is significant to the registrant. Significance is measured using a sliding scale and if the acquisition is deemed significant, the registrant must file separate audited annual financial statements and unaudited interim abbreviated income statements of the acquired business. Most notably, these final amendments modify the tests of significance,

limit the required annual financial statements of the acquired entity to two years, revise the required proforma financial information for acquisitions, allow for the use of abbreviated financial statements of a significant acquisition, align the criteria of Rule 3-05 with acquisitions by real estate entities, and include other minor changes.

However, despite the SEC’s desire to improve the reporting for acquisitions, they did not revise their definition of a business to reconcile with Generally Accepted Accounting Principles (“GAAP”). GAAP and the SEC each have their own unique framework to determine what is a business combination versus an asset acquisition. The financial reporting requirements differ considerably between an asset acquisition and a business combination and yet it remains possible that an acquisition may be considered a business combination under the SEC but an asset acquisition under GAAP.

Key Changes to the Existing Framework

- The tests for significance used to determine the required disclosures for acquisitions and disposals of businesses were amended. The new investment test considers the registrant's market value rather than total consolidated assets. The new income test includes a new revenue component; the tests for both revenue and income from continuing operations must be met for the test to be considered significant. The significance threshold to report business disposals was increased to 20 percent from 10 percent.
- Registrants may use abbreviated financial statements for an acquired business that was previously a component of a larger entity without seeking SEC approval if certain conditions are met.
- The revised rules require registrants to present a maximum of two years of audited financial statements of an acquired business rather than three years and allow IPOs to exclude pre-acquisition financial statements of acquired businesses in certain cases.
- Pro forma financial reporting has been simplified by clarifying the types of pro forma adjustments necessary and also allow the registrant to disclose forward-looking adjustments that meet certain criteria.

Revisions to Proposed Amendments

The original proposed changes issued in May 2019 were subject to input from various constituents and re-deliberation by the SEC, which resulted in a few modifications that are reflected in the final amendments. Most notably:

- The market value of the registrant used for the investment test is a five-day average rather than a single day as originally proposed.

- Continuing income from operations before income taxes is used in the income test rather than net income as originally proposed.
- IPOs can omit the otherwise required financial statements of significant acquisitions under certain conditions, if the registrant's audited financial statements include at least nine months of the acquiree's operations rather than one year as originally proposed.
- The use of forward-looking adjustments such as anticipated synergies ("Management's Adjustments") in the pro forma information of acquisitions is at the option of the registrant rather than required as originally proposed.
- The final amendments also included a number of minor changes and clarifications for the proposals.

These amendments become effective at the beginning of a registrant's fiscal year that starts after December 31, 2020 (e.g., January 1, 2021, for calendar-year-end companies); however, voluntary compliance is permitted before the effective dates as long as the final rule is applied in its entirety.

— 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 pre-clearance 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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