Proskauer

The SEC Makes Sweeping Changes to The M&A Financial Statement and Pro Forma Requirements

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Introduction

On May 21, 2020, the Securities and Exchange Commission (the "SEC") amended the financial statement and other disclosure requirements that apply when public companies acquire or dispose of a business or real estate operations.[1] The amendments simplify and rationalize the current rules, and should on balance decrease the regulatory burdens on public companies. The amendments continue the SEC's focus on reducing the regulatory burdens on public companies and facilitating access to public capital as part of its Disclosure Effectiveness initiative announced in 2013. While the changes are not effective until January 1, 2021, voluntary early compliance is permitted if the amendments are applied in their entirety from the date of early compliance.[2]

Among other things, the amendments:

- Reduce maximum years of historical financials provided under Rule 3-05 from three years to two.
- Modify the tests to measure significance of acquisitions and dispositions, including adding a revenue component to the income test that should operate more effectively for businesses with marginal or break-even net income, revising the investment test to use aggregate worldwide market value instead of total assets of the acquiring company, and expanding the circumstances when companies can use pro forma financials for purposes of measuring significance.
- Allow management adjustments to pro forma financials – permitting companies to address merger synergies – largely in response to criticism that pro forma financials do not always communicate useful information.
- Shorten the time when historical financials have to be included in the acquiring company's post-transaction financial statements.
- Increase the significance threshold for dispositions from 10% to 20% to conform with the minimum significance threshold for acquisitions.

- For foreign businesses, permit the use of, or reconciliation to, InternationalFinancial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB") in certain circumstances.

The SEC did not amend Form S-4 or Form F-4, and there are circumstances when those forms could still require three years of financial statements of the target. However, the changes to the significance tests will impact when target financial statements are required to be included on those forms.

In addition to revising the rules applicable to acquisitions and dispositions of businesses, the SEC also revised Rule 3-14 of Regulation S-X ("Rule 3-14") and the other rules applicable to acquisitions of real estate operations, and revised the financial statements requirements applicable to investment companies. This Client Alert focuses primarily on the changes to Rule 3-05 ("Rule 3-05") and Article 11 of Regulation S-X and the related rules and forms. For further information on the amendments to Rule 3-14 and new Rule 6-11, which applies to investment companies and business development companies subject to the Investment Company Act of 1940, please see our alerts available here and here.

Background – Financial Statements Required in Connection with Acquisitions and Dispositions

When a registrant acquires a significant business, Rule 3-05 of Regulation S-X generally requires the registrant to provide separate audited annual and unaudited interim pre-acquisition financial statements for that business. The number of years covered by these financial statements varies depending upon the relative significance of the acquired business to the registrant. Regulation S-X provides that historical target company financial statements are required depending on the significance of the acquired business, measured using three tests: the investment test, the income test and the asset test. If any one of the three tests exceeds the minimum 20% threshold, then audited financial statements for the target company must be provided.

Article 11 of Regulation S-X (and Article 8 for smaller reporting companies) requires a registrant to provide unaudited pro forma financial information relating to a significant acquisition or disposition. Pro forma financial information typically includes a pro forma balance sheet and pro forma income statements based on the historical financial statements of the registrant and the acquired or disposed business, including adjustments intended to show how the acquisition or disposition might have affected the registrant's financial statements.

These historical financial statements and pro forma financial information are generally required to be included in registration statements for securities offerings under the Securities Act of 1933. They are also required to be included in filings on Form 8-K that disclose material acquisitions or dispositions (either in the initial Form 8-K or in an amended Form 8-K filed within 71 days after the original filing deadline).

The amendments to the application of these requirements are summarized below.

Amended Rules: Reduced Fiscal Periods

The final amendments reduce the number of years of required target financial statements for the most significant acquisitions from three years to two years, and from two years to one year for other acquisitions. The final amendments also require unaudited financial statements only for the most recent interim period unless the significance of the target exceeds 40%, in which case interim financial statements for the corresponding prior interim period are still required. The changes to the periods required for target financial statements are summarized in the following table:

Target Financial Statements Required

Significance Level	Existing	Amended
Significance of an individual acquisition does not exceed 20%	No financial statements required	No financial statements required
Significance of an individual acquisition (or group of related acquisitions) exceeds 20% but does not exceed 40%	Most-recent fiscal year (audited) and any interim period and the corresponding prior year interim period (unaudited)	Most-recent fiscal year (audited) and any interim period (unaudited), without the corresponding prior year interim period

Target Financial Statements Required

Significance Level	Existing	Amended
Significance of an individual acquisition (or group of related acquisitions) exceeds 40% but does not exceed 50%	Two most-recent fiscal years (audited) and any interim period and the corresponding prior year interim period (unaudited)	Two most-recent fiscal years (audited) of audited financial statements, and any interim period and the corresponding year interim period (unaudited)
Significance of aggregate of all completed and probable acquisitions exceeds 50%	Three most-recent fiscal years (audited) and any interim period and the corresponding prior year interim period (unaudited)	Two most-recent fiscal years (audited) of audited financial statements, and any interim period and the corresponding year interim period (unaudited)

Revised Significance Tests

Regulation S-X provides that historical target company financial statements are required depending on the significance of the acquired business, measured using three tests: the investment test, the income test and the asset test. The final amendments change how the investment test and the income test are measured. The three significance tests are summarized in a simplified form in the following table, both before and after the final amendments:

Investment Test	Income Test	Asset Test
Test Before Amendments[1]		
Investment in and advances to the target ÷ Total assets of registrant	Registrants' share of net income from continuing operations of target before tax ÷ Registrant's net income before tax and other deductions	Total assets of target ÷ Total assets of registrant

Investment Test	Income Test	Asset Test
	Revised Test(1)	
Investments in/advanced to acquired business ÷ Five-day average aggregate worldwide market price of common equity	***Lower of:*** Total annual revenues of target ÷ Total annual revenue of registrant ***Or*** Registrant's share of target net income (or absolute value of net loss) from continuing operations, before tax ÷ Registrant's net income (or absolute value of net loss) from continuing operations before tax	Total assets of target ÷ Total assets of registrant

(1) This table presents simplified versions of the significance tests, and applying the tests requires reference to the applicable rules in Regulation S-X and the guidance provided by the SEC in the Financial Reporting Manual and elsewhere.

Changes to the Investment Test

Prior to the final amendments, the investment test compared the acquiring registrant's investments in and advances to the target (generally, the purchase price in the acquisition calculated in accordance with U.S. GAAP) against the registrant's total assets reflected in its most recent annual financial statements required to be filed prior to the acquisition of the target. Under the final amendments, the investment test has been revised, solely for purposes of determining significance with acquisitions and dispositions, to compare the registrant's investments in and advances to the target to the aggregate worldwide market value of the registrant's voting and non-voting common equity.[3] The final amendments effectively require the comparison of the acquiring registrant's market value to the purchase price of the target company. For IPO companies or companies that are otherwise not publicly traded and worldwide market value of the registrant's securities is not readily available, the final rules continue to require the use of the book value of total assets of the registrant and its consolidated subsidiaries for the investment test.

The amendments also require that "investments in" the target company include the fair value of contingent consideration (such as earn-outs), so long as that contingent consideration is required to be recognized at fair value by the issuer at the acquisition date under U.S. GAAP or IFRS, as applicable. If the contingent consideration is not required to be recognized at fair value, then all contingent consideration must be included in the purchase price, except to the extent payment of all or any portion of the contingent consideration is remote.

Changes to the Income Test

Before the amendments, the income test compared the income from continuing operations before income taxes of the target to the corresponding income of the registrant. As amended, a new revenue component has been added to the income test, allowing registrants to compare the revenue of the target to their own revenue if that test results in a lower significance level than comparing the income of the target to the registrant's income. The SEC staff in many cases has granted waivers to the existing rules allowing registrants to exclude the financial statements of targets that exceeded 20% under the income test but would have had a lower significance when comparing revenues. This change to the income test allows registrants to look at revenue as the significance measure without the burden of seeking a waiver from the staff and should provide a more accurate test of the actual materiality of a target to the registrant, particularly for start-up and early-stage companies that have not yet started generating income. The changes will also help to avoid anomalous results that trip the income test for unusual impacts on a company's net income that are unrelated to the actual significance of a particular target.

Under the amendments, when the registrant and the target have "material" annual revenue for each of the most recently completed two fiscal years, the target company's revenue and income must represent at least 20% of both revenue and operating income of the registrant to trigger the test.[4] Also, under those circumstances, the issuer may use the lower of the revenue component and the income component to determine the number of periods for which target company financial statements are required, assuming neither the investment test nor the asset test requires additional years to be provided. If the target company does not exceed both of these components by at least 20%, the acquisition is not considered significant for purposes of the income test. The amendments retain the current requirement to use income or loss from continuing operations before income taxes ("consolidated income or loss") for purposes of the income test.[5]

The amendments also specify that the income component of the income test be determined by comparing the "absolute value" of the consolidated income or loss of the target with the absolute value of the consolidated income or loss of the registrant. If the revenue component does not apply, and the absolute value of the registrant's consolidated income or loss is at least 10% lower than the average of the absolute value of those amounts for the last five years, then the registrant may use the five-year average of the absolute value of consolidated income or loss. Average income should be calculated using the absolute value of the loss or income amounts for each year and then calculating the average.[6]

Using Pro Forma Financial Information to Measure Significance

The amendments also expand the circumstances when registrants can use pro forma financial information to measure significance. Registrants will now be permitted to measure significance using pro forma financial information that depicts significant business acquisitions and dispositions consummated after the latest fiscal year end for which the registrant's financial statements are required to be filed. However, the registrant may do so only with respect to acquisitions or dispositions for which historical target company financial statements and pro forma financial information have been filed with the SEC.[7] Registrants that use pro forma financial information to measure significance are required to continue to do so until the registrant files its next annual report on Form 10-K or Form 20-F.

When using pro forma financial information to determine significance, registrants are not permitted to include any "management's adjustments" or "autonomous entity adjustments." See the section "*Adjustments to Acquisition Pro Formas*" below for a discussion of each of these adjustments.

Foreign Businesses

The amendments also revise the rules permitting the use of financial statements prepared in accordance with IFRS and the guidelines of the IASB when registrants acquire a company organized outside of the U.S. As amended, the rules permit target financial statements to be prepared in accordance with IFRS without reconciliation to U.S. GAAP if the acquired business would qualify to use IFRS if it were a registrant. The amendments also permit foreign private issuers that prepare their financial statements using IFRS to provide target financial statements of foreign businesses prepared using home country GAAP to be reconciled to IFRS rather than to U.S. GAAP. The financial statements of acquired businesses that do not meet the definition of a foreign business, but would qualify as foreign private issuers if they were registrants, may be reconciled to IFRS rather than U.S. GAAP if the acquirer is a foreign private issuer that uses IFRS. This change will benefit registrants in circumstances when under current rules they would be required to prepare a one-time presentation of the U.S. GAAP reconciling information for the financial statements of a target that may be of limited value to investors.

Individually Insignificant Acquisitions

Historically, the rules have required registrants to file the financial statements of some individually insignificant targets when the aggregate significance of such targets exceeded 50% under one of the three significance tests. The amendments still require pro forma financial information depicting the aggregate effects of all such acquisitions that together exceed 50% significance, but historical financial statements will be required only for those businesses whose individual significance exceeds 20% (but for which the registrant is not yet required to file financial statements because the closing of the acquisition is within the allowed filing timeframe under Rule 3-05 for individual acquisitions). The SEC acknowledged that auditors may be reluctant to provide negative assurance to underwriters on combined pro forma financial information where historical financial statements included in the pro forma financial information for individually insignificant acquisitions have not been reviewed or audited, but stated that while auditors may need to perform additional steps to meet "reasonable care" and "reasonable investigation" standards, these additional steps do not outweigh the need to simplify and improve the usefulness of information provided to investors.

Impact on Target Financial Statements Included in Form S-4 or Form F-4

If the acquisition of the target company is subject to a shareholder vote, the requirements of Form S-4 or Form F-4 will control what historical financial statements must be included for the target company in the proxy statement or proxy statement/prospectus, and the amendments did not make any changes to Form S-4 or Form F-4. Accordingly, in some circumstances, registrants may still be required to include two or three years of the target's financial statements in a Form S-4 or Form F-4, even when they would not be required to include as many years with a Form 8-K or another registration statement. However, if Regulation S-X requires the issuer to include in its proxy statement/prospectus historical financial statements for a target in an unrelated acquisition, the modified time period requirements set forth in the final amendments would apply to that unrelated target company. Further, the changes to the significance tests discussed above will reduce the circumstances when target financial statements relating to an acquisition subject to shareholder approval are required to be included in a Form S-4 or Form F-4.[8]

Adjustments to Acquisition Pro Formas

The amendments also revised the rules with respect to the presentation of pro forma financial information. They replace the existing adjustment requirements for pro forma financial statements with the three categories of adjustments set forth in the following table:

Pro forma adjustments

Transaction Accounting Adjustments (required)	Adjustment to reflect the U.S. GAAP or IFRS accounting for the transaction.
Autonomous Entity Adjustments (required)	Adjustment to reflect the operations and financial position of the registrant as an autonomous entity when the registrant was previously part of another entity.

Pro forma adjustments	
Management's Adjustments (optional)	Adjustment to reflect synergies and dis-synergies of the transaction as of the most recent practicable date. If these adjustments are included, there must be a reasonable basis for each adjustment, all adjustments necessary in management's judgment to a fair statement of the pro forma effects must be presented, and the adjustments must be limited to the effects as if the synergies and dis-synergies existed at the beginning of the period. In order to enhance comparability, these adjustments must be presented in the explanatory notes to the pro forma financial information as a reconciliation to pro forma net income, and disclose the basis for and material limitations of each Management's Adjustment.

In a change from the amendments proposed in 2019, the final amendments make the Management's Adjustments optional, although the Adopting Release encourages registrants to include them if the conditions in the new rule are met. Any forward-looking information supplied will be expressly covered by the safe harbors under Rule 175 under the Securities Act and Rule 3b-6 under the Exchange Act.

Including Management's Adjustments may cause difficulties or complications, given the forward-looking, potentially sensitive and uncertain nature of transaction synergies and dis-synergies and the potential need to update previously filed pro formas in future filings in order to show Management's Adjustments as of the most recent practicable date.

Shortened Time for Inclusion of Historical Target Financial Statements

Prior to the final amendments, Regulation S-X generally permits a registrant to omit financial statements otherwise required by Rule 3-05 in registration statements and proxy statements if the operating results of the acquired business have been reflected in the audited consolidated financial statements of the registrant for a complete fiscal year. However, this omission is not permitted if either the target's financial statements have not been previously filed, or have been previously filed, but the acquired business is of "major significance" to the registrant.

Under the final amendments, Rule 3-05 financial statements will no longer be required in registration statements and proxy statements once the acquired business is reflected in the registrant's post-acquisition audited financial statements, regardless of whether previously filed, if the results are reflected for the applicable time period. The amendments allow omission of pre-acquisition financial statements for businesses that exceed 20% significance but do not exceed 40% significance once they are included in the registrant's audited post-acquisition results for nine months. For businesses that exceed 40% significance, pre-acquisition financial statements may be omitted once the operating results of the acquired business are included in the registrant's post-acquisition results for a complete fiscal year.

Dispositions of Businesses

Under the existing rules, a registrant must file pro forma financial information for any disposition of a business that exceeds the 10% significance threshold. The new rules increase the significance threshold for dispositions of businesses to 20%, to match the threshold applicable to acquisitions of businesses. The changes to the significance tests described above also apply to dispositions of businesses. Unlike in the case of a significant acquisition, however, where a registrant generally benefits from a 75-day post-closing grace period to file the required historical financial statements and pro forma financial information under Item 9.01 of Form 8-K, a registrant must file pro forma financial information reflecting a disposition within four business days of closing. The new rules do not change that timing, nor do they change the Item 2.01 8-K trigger threshold for acquisitions or dispositions of assets that do not constitute a business.

Significance (current)	Significance (amended)	Requirements
Less than 10%	Less than 20%	No pro forma financial statements required

Significance (current)	Significance (amended)	Requirements
Greater than 10%	Greater than 20%	Unaudited pro forma balance sheet as of the end of the most recent period for which consolidated balance sheet of the registrant is required Unaudited pro forma income statement for registrant’s most recent fiscal year Pro forma interim income statement

Smaller Reporting Companies

In 2018, the SEC significantly expanded the number of smaller reporting companies by revising the public float threshold necessary to qualify as a smaller reporting company, and by adding a revenue test to the determination.[9] The final amendments make changes to the target company financial statements required for smaller reporting companies. Rule 8-05 of Regulation S-X has been revised to require that the preparation, presentation and disclosure of pro forma financial information by smaller reporting companies substantially comply with Article 11. Rule 8-04 of Regulation S-X has been revised to direct registrants to Rule 3-05 for the requirements relating to the financial statements of businesses acquired or to be acquired, other than for form and content requirements for such financial statements, which would continue to be prepared in accordance with Rules 8-02 and 8-03 of Regulation S-X. Further, because Part F/S of Form 1-A refers to Rule 8-05, the revisions to Rule 8-05 apply to issuers relying on Regulation A as well.

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[1] SEC Release No. 33-10786; 34-88914 (May 21, 2020), available at https://www.sec.gov/rules/final/2020/33-10786.pdf. (the “Adopting Release.”)

[2] Although companies may voluntarily apply the new rules, those that file a Form 8-K under Item 2.01 announcing an acquisition or disposition of a business before January 1, 2021 that have not yet filed required financial statements must use the existing rules to prepare those financial statements and accompanying pro forma financial statements, and to determine whether such financial statements are required.

[3] The worldwide market value is calculated as the average of the daily worldwide market value for the last five trading days of the most recently completed month end prior to the announcement or agreement date of the acquisition or disposition.

[4] The SEC did not define what “material” revenue means for these purposes, and originally proposed allowing the revenue component of the income test to be used when the target and registrant both had “recurring” revenue. Rather than requiring that revenue has exceeded any particular dollar threshold, we think that the revenue of each company should be compared to its own operations for purposes of determining whether or not it is “material” for these purposes. Absent further guidance from the SEC staff, we think that a target small operating company that generates revenue from operations should be considered to have “material” revenue, even if the dollar amount of such revenue is relatively small compared to the registrant’s operations.

[5] In the proposing release, the SEC proposed modifying the calculation of income or loss from continuing operations to be after income taxes, as opposed to the current rules which require the calculation before income taxes. This proposed change was not included in the final amendments.

[6] Under current SEC guidance in Section 2015.8 of the Financial Reporting Manual, the SEC staff has indicated that zero should be used for loss years in computing the average.

[7] The SEC staff previously permitted the use of pro forma financial information to measure significance only when the issuer made a significant acquisition after its latest fiscal year-end and filed target company financial statements and pro forma financial information relating to the acquisition on Form 8-K with the SEC. See Section 3110 of the Financial Reporting Manual.

[8] See footnote 9 of the Adopting Release.

[9] See the definition of "smaller reporting company" in Item 10(e) of Regulation S-K and Rule 12b-2 of the Exchange Act.

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