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WHITE PAPER

June 2020

SEC Improves Financial Disclosure Requirements for Acquisitions and Dispositions

On May 21, 2020, the Securities and Exchange Commission ("SEC") adopted amendments to its financial disclosure requirements related to acquisitions and dispositions. These amendments streamline and eliminate immaterial disclosure requirements relating to acquisitions and dispositions and are designed to reduce the complexity and compliance costs associated with existing requirements. The amendments are effective January 1, 2021, but issuers may voluntarily choose to comply with the new rules in lieu of the current rules in advance of the effective date.

TABLE OF CONTENTS

The most significant changes to the financial disclosure requirements of the Securities and Exchange Commission ("SEC") include:

- Revising the SEC significance tests to (i) update the "investment test" to compare the registrant's investments in the acquired business to the aggregate worldwide market value of the registrant's voting and non-voting common equity (as applicable); (ii) update the "income test" to add a revenue component; (iii) expand the use of pro forma financial information in measuring significance; and (iv) increase the threshold for dispositions from 10% to 20%;

- Requiring financial statements of the acquired business only for a maximum of the two most recent fiscal years;

- No longer requiring separate acquired business financial statements, even for "major" acquisitions, once the business has been included in the registrant's post-acquisition financials for nine months or a complete fiscal year (depending on significance); and

- Updating the pro forma financial information requirements to improve the content and relevance by (i) providing for "transaction accounting adjustments" and "autonomous entity adjustments"; and (ii) permitting registrants to disclose certain "management's adjustments" for synergies, dis-synergies, and certain other effects of the transaction that are not currently permitted under SEC rules, if the adjustments would enhance an understanding of the pro forma effects of the transaction and certain other conditions are met.

OVERVIEW

Under Rule 3-05 of Regulation S-X, a registrant that acquires a significant business is typically required to provide both audited annual and unaudited interim pre-acquisition financial statements of the business. If the acquisition is "significant" under any of the investment, asset, or income tests in Rule 1-02(w) of Regulation S-X, then up to three years of pre-acquisition financials may be subject to disclosure obligations.

Article 11 of Regulation S-X requires unaudited pro forma financial information relating to an acquisition or disposition in connection with the filing of historical financial statements. This disclosure generally 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.

UPDATES TO SEC SIGNIFICANCE TESTS

The SEC amended the significance tests in Rule 1-02(w) to improve their application and to assist registrants in making more meaningful determinations of whether a subsidiary or an acquired or disposed business meets the necessary threshold as "significant." The most consequential changes were made to the investment test and the income test, while the asset test remains largely consistent with the current regulation.

Investment Test

The investment test currently compares the registrant's investments in, and advances to, the acquired business to the total assets of the registrant (and its subsidiaries). The revised investment test compares the registrant's (and its subsidiaries') investments in, and advances to, the acquired business to the aggregate worldwide market value of the registrant's voting and non-voting common equity as of the most recently completed month. In circumstances where the registrant does not have an aggregate worldwide market value, the prior test will remain in place.

Income Test

The income test currently compares the registrant's equity in the acquired business's income from continuing operations before income taxes to such income of the registrant. The revised income test has been supplemented with a revenue component in order to reduce the anomalous result that registrants with marginal or break-even net income or loss in a recent fiscal year, may be more likely to have tested acquired businesses deemed significant. This anomaly is particularly relevant where it would require Rule 3-05 financial statements for acquisitions that otherwise would not be considered material to investors. Under the final amendments, the tested subsidiary must meet both the revenue component and the net income component of the income test when the revenue component applies. For purposes of the application of Rule 3-05, registrants may use the lower of the revenue component and the net income component to determine the number of periods for which Rule 3-05 financial statements are required.

Using Pro Forma Financial Information to Measure Significance

Currently, a registrant may use pro forma, rather than historical, financial information to test significance of a subsequently acquired business if the registrant completed a significant acquisition after the latest fiscal year-end and has filed its pre-acquisition and pro forma financial information on a Form 8-K. The amended rules permit registrants to measure significance using pro forma financial information related to dispositions, in addition to acquisitions, and also permit the use of pro forma information in significance-testing for initial public offering registration statements, in each case subject to certain conditions.

Significance Thresholds for Dispositions

The amended rules increased the significance threshold for dispositions from 10% to 20%, aligning the significance threshold for dispositions with the significance threshold for acquisitions, and made other conforming changes to harmonize the application of the significance test for dispositions with the test for acquisitions.

FINANCIAL STATEMENT REQUIREMENTS FOR ACQUIRED BUSINESSES

Periods Presented

The final amendments eliminate the requirement to include the earliest of the three years of pre-acquisition financial statements presently required for an acquisition that exceeds 50% significance. In amending the rules, the SEC noted that the third year of Rule 3-05 financial statements is less likely to be indicative of the current financial condition and results of operations of the acquired business.

Omission of Financial Statements

Under current Rule 3-05, required financial statements may be omitted once the acquired business has been reflected in the audited consolidated financial statements of the registrant for a complete fiscal year. However, if the financial statements have not been previously filed or the acquired business is of "major" significance to the registrant (which in practice is considered to be at the 80% or higher significance level), the period for which separate Rule 3-05 financial statements must be filed is extended. The amended rule eliminates the requirement to include Rule 3-05 financial statements once the acquired business is reflected in the registrant's financial statements for a period of either nine months (for acquired businesses that exceed the 20% significance threshold but do not exceed 40% significance) or a complete fiscal year (in all other cases).

Individually Insignificant Acquisitions

Presently, unrelated acquired businesses that do not individually meet the significance threshold may be aggregated in certain instances to exceed 50% significance. In such cases, historical audited financial statements along with the related pro forma financial information for those businesses constituting the majority of the group are required. The amendments eliminate the requirement of historical financial statements except in the case of businesses with individual significance exceeding 20%.

PRO FORMA FINANCIAL INFORMATION

Under Article 11 of Regulation S-X as currently in effect, a pro forma income statement may only reflect adjustments that are directly attributable to the transaction, that are expected to have a continuing impact on the registrant beyond the closing of the transaction, and that are factually supportable. The pro forma balance sheet, by contrast, can reflect adjustments that may or may not have a continuing impact, so long as the adjustments are both directly attributable to the transaction and are factually supportable. The amendments have modified this existing criteria with three categories of pro forma adjustments—Transaction Accounting Adjustments and Autonomous Entity Adjustments, both of which are required under the revised rule, and Management's Adjustments, which may be presented if the registrant's management is of the opinion that the adjustments would enhance an understanding of the effects of the transaction.

Transaction Accounting Adjustments

Transaction Accounting Adjustments reflect the impact of the transaction projected by accounting for the transaction as required by U.S. GAAP or IFRS, as applicable. These adjustments are incorporated into the pro forma condensed balance sheet and the effects of those pro forma balance sheet adjustments are reflected in the pro forma condensed income statements, assuming the adjustments were made as of the beginning of the fiscal year presented. If no balance sheet effect arises from this modification, then the accounting should be consistent with U.S. GAAP or IFRS. The amendments also clarify that pro forma statement of comprehensive income adjustments must be made whether or not the pro forma balance sheet is presented.

Autonomous Entity Adjustments

Autonomous Entity Adjustments are those adjustments made to reflect the status of operations and financial position of a registrant that previously was not an independent entity, as such financial and operational information would have been previously disclosed if it were an autonomous entity. The amendments require a description of the adjustments made and any material uncertainties, the material assumptions used to make such adjustments, the calculation methodology, and additional qualitative information necessary to give a fair and balanced presentation of the pro forma financial information.

Management's Adjustments

The amended rules permit registrants to disclose certain "management's adjustments" for synergies, dis-synergies, and certain other effects of the transaction that are not currently permitted under SEC rules. If a registrant presents management's adjustments, the adjustments must be presented in a consistent manner and cannot create misleading disclosure. Several conditions apply in connection with using management's adjustments, including that each adjustment has an independent reasonable basis, that when synergies are presented, any related dis-synergies are also presented, and that the adjustments made are limited in scope and only disclosed to the extent that the registrant's management believes necessary to a fair statement.

OTHER CHANGES

Real Estate Operations

The amended rules align Rule 3-14 governing acquired real estate operations with Rule 3-05 in most instances in an effort to reduce complexity by standardizing the requirements for acquired businesses overall.

Carve Outs

The SEC acknowledged that registrants frequently acquire a component of an entity that is a business as defined in Rule 11-01(d), but does not constitute a separate entity, subsidiary, or division. These businesses may not have separate financial statements or maintain separate and distinct accounts necessary to prepare Rule 3-05 financial statements and so making relevant allocations of the selling entity's corporate overhead, interest, and income tax expenses necessary to provide comprehensive financial statements can be impracticable. In recognition of these challenges, the new amendments have outlined abbreviated financial statement requirements and limited additional required disclosures in certain circumstances.

Foreign Private Issuers

The new amendments have updated Rule 3-05(c) to allow foreign private issuers that prepare their financial statements using IFRS to reconcile Rule 3-05 financial statements of foreign businesses prepared using the registrant's home country GAAP to IFRS rather than U.S. GAAP. The reconciliation to IFRS is required generally to follow the form and content requirements in Item 17(c) of Form 20-F.

Smaller Reporting Companies

The amended rules include corresponding changes to the smaller reporting company requirements in Article 8.

Investment Companies

The amendments contain a definition of "significant subsidiary" to Regulation S-X that is specifically tailored for investment companies. In connection with these changes, the existing pro forma financial information requirement will be replaced with a requirement to provide supplemental financial information.

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