KIRKLAND & ELLIS

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SEC Amends Acquired Business Financials Disclosure Rules

The Amended Rules

On May 20, 2020, the US Securities and Exchange Commission ("SEC") issued a final rule release amending its rules on disclosure of financial information about acquired or disposed businesses. The rule amendments will become effective January 21, 2021, but SEC reporting companies will not be required to comply with the amended rules until the beginning of the SEC reporting company's first fiscal year starting after December 31, 2020. IPO registration statements filed on or after December 31, 2020 will be required to conform to the amended rules. The SEC noted that companies can voluntarily comply with the amended rules in advance of the effective date (but would need to comply with the amended rules in their entirety). If a company has already filed an Item 2.01 8-K but has not yet filed the required financial statements, the company must comply with the prior rules.[1]

Target (3-05) and Pro Forma (Article 11) Financials

When a public company acquires a "significant" business, Regulation S-X requires the acquiror to file with the SEC:

- separate audited annual and unaudited interim pre-acquisition historical financial statements of the target ("Target Historical Financials");
- pro forma financial statements based on the historical financial statements of the acquiror and target, adjusted to show how those financials might have been affected had the acquisition occurred on an earlier date ("Pro Forma Financials" and, together with Target Historical Financials, "Acquired Business Financials").

The Acquired Business Financials are required to be filed with the SEC in a Form 8-K within 75 days of the closing date of the acquisition.

Timing of Filing Acquired Business Financials

The SEC's May 20, 2020 release specified that Acquired Business Financials are required:

- *Most Recent Fiscal Year:* if the acquisition closed during the acquiror's most recent fiscal year
- *Subsequent Quarters:* if the acquisition closed during any subsequent quarter after the acquiror's most recent fiscal year
- *After the Most Recent Quarter:* if the acquisition closed or is probable to close after the last day of the acquiror's most recent quarter

1. The SEC's May 20, 2020 release amends financial disclosure rules specifically related to **real estate operations, oil & gas businesses, smaller reporting companies,** and **investment companies**, but details of those amendments are beyond the scope of this client alert.

Significance Tests: Income Test

Significance Tests

An acquiror is only required to file Acquired Business Financials with the SEC if the target would become a "significant subsidiary" of the acquiror under Rule 1-02(w) of Regulation S-X. The target will be considered a "significant subsidiary" if it is greater than 20% significant under any of the following three tests, which were amended by the SEC in its May 20, 2020 release as shown in the chart below:

CURRENT TEST

$$\frac{\text{target's pre-tax annual income}}{\text{acquiror's pre-tax annual income}}$$

(in most recent annual financials prior to the acquisition closing date)

CHANGES

New Revenue Test. Added a revenue test (in addition to the existing pre-tax income test) if the acquiror and the target have "recurring annual revenues", meaning material revenue in each of the two most recently completed fiscal quarters.

How Many Years of Financials? To determine how many years of target financials are required to be filed with the SEC, the acquiror can use the lower of the results of the new revenue test and the existing pre-tax income test.

Absolute Value. If pre-tax income is negative, use the absolute value in the income test calculation.

Acquiring Part of a Company. If the acquiror is acquiring part of a company (not the whole company), certain corporate overhead, interest, and income tax expenses may be able to be excluded from the numerator (see "Acquiring Part of a Company" below).

10-K Filed After Acquisition Closing but Before Acquired Business Financials Filed. Acquiror can choose whether to calculate significance based on its most recent annual financials filed before the acquisition closing date or before filing the Acquired Business Financials to eliminate any incentive to delay filing the 10-K.

AMENDED TEST

New Revenue Test

If the acquiror and target have recurring annual revenues, the income test will only be met if both the new revenue test and the existing net income test are met:

$$\frac{\text{target's consolidated total revenues from continuing operations (after intercompany eliminations)}}{\text{acquiror's consolidated total revenues}}$$

AND

$$\frac{\text{target's pre-tax annual income}}{\text{acquiror's pre-tax annual income}}$$

(in both cases in the most recent annual financials (at the acquiror's option) (1) prior to the acquisition closing date or (2) prior to filing the Acquired Business Financials))

Significance Tests: Investment Test

CURRENT TEST

$$\frac{\text{acquiror's investments in the target } \textit{(i.e. the acquisition consideration)}}{\text{acquiror's total assets}}$$

(reported in most recent annual financials filed by the acquiror with the SEC prior to the acquisition closing date)

CHANGES

Total Assets → Market Value. For both acquisitions and dispositions, replace acquiror's total assets in the denominator with, if it exists, the acquiror's average aggregate worldwide market value of voting and non-voting common equity calculated daily for the last five trading days of the acquiror's most recently completed month ending before the earlier of the date on which the acquiror (i) announces the acquisition or (ii) signs an acquisition agreement ("Market Value").Contingent Consideration. For acquisitions only, include in the numerator the fair value of contingent consideration if it is required to be recognized at fair value by the acquiror on the closing date of the acquisition under US GAAP or IFRS or, if it is not required to be recognized at fair value, the numerator must include all contingent consideration unless the likelihood of payment is remote.

10-K Filed After Acquisition Closing but Before Acquired Business Financials Filed. Acquiror can choose whether to calculate significance based on its most recent annual financials filed before the acquisition closing date or before filing the Acquired Business Financials to eliminate any incentive to delay filing the 10-K.

Assets Transferred by Acquiror. Numerator excludes the acquiror's proportionate interest in the carrying value of assets transferred by the acquiror to the target that will remain with the combined entity after the acquisition.

Net Book Value. Investment test will be met if the net book value of the target >10% of the acquiror's total assets.

Stock Consideration / Common Control. In a combination of entities or businesses under common control, if the acquiror is paying all or a portion of the consideration with its own stock, the investment test will be met if the number of common shares exchanged > 10% of the acquiror's total common shares outstanding.

AMENDED TEST

Acquisitions / Market Value Exists

If an acquiror has a Market Value (new test):

$$\frac{\text{acquiror's investments in the target}}{\text{acquiror's Market Value}}$$

Acquisitions / No Market Value

If an acquiror does not have a Market Value or if significance is being tested for any purpose other than determining required Acquired Business Financials, including testing the significance of equity method investees under Rule 3-09 and 4-08 of Regulation S-X (retain old test):

$$\frac{\text{acquiror's investments in the target}}{\text{acquiror's total assets}}$$

(reported in most recent annual financials filed by the acquiror with the SEC either (at the acquiror's option) (1) prior to the acquisition closing date or (2) prior to filing the Acquired Business Financials))

Dispositions / Market Value Exists

For dispositions if the seller has a Market Value:

$$\frac{\text{fair value of the consideration for the disposition (including contingent)}}{\text{seller's Market Value}}$$

Dispositions / No Market Value

For dispositions if the seller does not have a Market Value:

$$\frac{\text{carrying value of the disposed entity}}{\text{seller's total assets}}$$

Significance Tests: Asset Test

CURRENT TEST	CHANGES	AMENDED TEST
$\frac{\text{target's total assets}}{\text{acquiror's total assets}}$ *(reported in most recent annual financials filed by the acquiror with the SEC prior to the acquisition closing date)*	No substantive changes, but the amended rules clarify that for acquisitions, intercompany transactions with the acquired business must be eliminated from the acquiror's and its subsidiaries' consolidated total assets when computing the test. **10-K Filed After Acquisition Closing but Before Acquired Business Financials Filed.** Acquiror can choose whether to calculate significance based on its most recent annual financials filed before the acquisition closing date or before filing the Acquired Business Financials to eliminate any incentive to delay filing the 10-K.	No substantive changes $\frac{\text{target's total assets}}{\text{acquiror's total assets}}$ *(reported in most recent annual financials (at the acquiror's option) (1) prior to the acquisition closing date or (2) prior to filing the Acquired Business Financials))*

The three significance tests are not only used under the SEC's rules to determine the significance of an acquired business. For example, they are also used to determine what financial information about a subsidiary needs to be filed with the SEC after an acquisition. To ensure consistent treatment before and after an acquisition, the SEC adopted conforming changes to the definition of "significant subsidiary" in Rule 405 of the Securities Act of 1933 and Rule 12b-2 under the Exchange Act of 1934.

Dispositions

The SEC's May 20, 2020 release conformed the significance tests for dispositions to the significance tests for acquisitions, notably raising the lowest threshold for disclosure from 10% to 20% significance.

Target Historical Financials

How Many Years of Target Historical Financials Must Be Filed?

An acquiror is required to file one, two, or three years (and any interim periods) of Target Historical Financials depending on how significant the acquisition is to the acquiror. The SEC's May 20, 2020 release amended these requirements as follows:

SIGNIFICANCE LEVEL	CURRENT REQUIREMENT	CHANGES	AMENDED REQUIREMENT
≤ 20%	None	No changes	None
> 20% ≤ 40%	One year (audited) + Any interim periods (unaudited)	"Most recent" (instead of "any") interim period required No comparative interim period required (since no annual comparative period is required)	One year (audited) + Most recent interim period only (unaudited)
> 40% ≤ 50%	Two years + Any interim periods (unaudited)	No changes	Two years (audited) + Any interim periods (unaudited)
>50%	Three years + Any interim periods (unaudited)	Requirement eliminated Three years of target historical financials never required regardless of the significance of the acquisition	Two years (audited) + Any interim periods (unaudited)

Pro Forma Financials

The SEC's May 20, 2020 release amended the adjustments that an acquiror is required or permitted to make in Pro Forma Financials as follows:

CURRENT RULES

An acquiror is required (and only permitted to) make adjustments in the income statement and balance sheet in Pro Forma Financials that are:

- directly attributable to the transaction; and
- factually supportable

Additionally in the income statement (but not the balance sheet) in Pro Forma Financials, an acquiror is required (and only permitted to) make adjustments that are:

- expected to have a continuing impact on the acquiror

AMENDED RULES

An acquiror is required to make the following adjustments in Pro Forma Financials (in separate columns):

- Transaction Accounting Adjustments
- Autonomous Entity Adjustments

Additionally an acquiror is permitted if it meets certain conditions (but not required) to make the following adjustments in the Pro Forma Financials (in a separate column):

- Management's Adjustments

Explanatory Notes

In the May 20, 2020 release, the SEC added a requirement that an acquiror disclose in the Explanatory Notes to Pro Forma Financials revenues, expenses, gains and losses, and related tax effects that will not recur in the income of the acquiror beyond 12 months after the acquisition.

Presentation

The SEC clarified in its May 20, 2020 release that pro forma financial information must be appropriately labeled as pro forma.

The SEC added that each transaction for which pro forma effect is required to be given must be presented in a separate column.

Transaction Accounting Adjustments

Definition

Transaction Accounting Adjustments are adjustments that reflect only the application of required accounting to the acquisition, disposition, or other transaction linking the effects of the target to the acquiror's audited historical financial statements.

Required vs. Optional

An acquiror is required to reflect Transaction Accounting Adjustments in Pro Forma Financials.

Balance Sheet

In a pro forma balance sheet, Transaction Accounting Adjustments are adjustments depicting the accounting for the acquisition required by US GAAP or IFRS.

Income Statement

In a pro forma income statement, Transaction Accounting Adjustments are adjustments that show the effects of the Transaction Accounting Adjustments made in the pro forma balance sheet, assuming those adjustments were made as of the beginning of the fiscal year (or if there is no effect or if no pro forma balance sheet is included, then showing the accounting for the acquisition required by US GAAP or IFRS). Historical and pro forma per share data that gives effect to Transaction Accounting Adjustments must be presented on the face of a pro forma income statement.

Explanatory Notes

The Explanatory Notes to Pro Forma Financials that include Transaction Accounting Adjustments must disclose:

- total consideration (including contingent consideration) transferred or received, including its components and how they were measured (and if contingent, the basis for determining the amount of payment(s) or receipt(s), and an estimate of the range of outcomes (undiscounted) or, if a range cannot be estimated, that fact and the reasons why); and
- if the initial accounting is incomplete, a prominent statement to this effect, the items for which the accounting depicted is incomplete, a description of the information that the acquiror requires, including uncertainties affecting the pro forma financial information and the possible consequences of their resolution, an indication of when the accounting is expected to be finalized, and other available information regarding the magnitude of any potential adjustments.

Autonomous Entity Adjustments

Definition

Autonomous Entity Adjustments are adjustments necessary to reflect the operations and financial position of the acquiror as an autonomous entity when the acquiror was previously part of another entity.

Required vs. Optional

An acquiror is required to reflect Autonomous Entity Adjustments in Pro Forma Financials.

Income Statement

Historical and pro forma per share data that gives effect to Autonomous Entity Adjustments must be presented on the face of a pro forma income statement.

Explanatory Notes

The Explanatory Notes to Pro Forma Financials that include Autonomous Entity Adjustments must disclose:

- a description of the Autonomous Entity Adjustments (including the material uncertainties)
- material assumptions
- the calculation of the adjustments;
- and qualitative information about the Autonomous Entity Adjustments necessary to give a fair and balanced presentation of the pro forma financial information.

Management's Adjustments

Definition

Management's Adjustments are adjustments that provide both flexibility to the acquiror to include forward-looking information that depicts the synergies and dis-synergies identified by management in determining to consummate or integrate the transaction for which pro forma effect is being given and insight to investors into the potential effects of the acquisition and the post-acquisition plans expected to be taken by management.

Required vs. Optional

An acquiror may at its option if it meets the conditions listed below (but is not required to) reflect Management's Adjustments in Pro Forma Financials.

Conditions

An acquiror will only be permitted to make Management's Adjustments in Pro Forma Financials if:

- there is a reasonable basis for the Management's Adjustments;
- the Management's Adjustments are limited to the effect of the synergies and dis-synergies on the historical financial statements that form the basis for the pro forma income statement as if the synergies and dis-synergies existed as of the beginning of the fiscal year presented;
- when synergies are presented, any related dis-synergies are also presented;
- if the Management's Adjustments reduce expenses, the reduction does not exceed the amount of the related expense historically incurred during the pro forma period presented;
- the pro forma financial information reflects all Management's Adjustments that are, in the opinion of management, necessary to a fair statement of the pro forma financial information presented and a statement to that effect is disclosed;
- Management's Adjustments included or incorporated by reference into a registration, proxy or offering statement or Form 8-K must be as of the most recent practicable date prior to the effective date, mail date, qualified date, or filing date as applicable (which may require that they be updated if previously provided in a Form 8-K that is incorporated by reference); and
- if the Management's Adjustments will change the number of shares or potential common shares, the change must be reflected within Management's Adjustments in accordance with U.S. GAAP or IFRS, as applicable, as if the common stock or potential common stock were outstanding as of the beginning of the period presented.

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Management’s Adjustments (Continued)

Explanatory Notes

The Explanatory Notes to Pro Forma Financials that include Management’s Adjustments must disclose:

- reconciliations of pro forma net income and earnings per share before and after giving effect to each Management’s Adjustment;.
- the basis for and material limitations of each Management’s Adjustment;
- any material assumptions or uncertainties of each Management’s Adjustment;
- an explanation of the method of the calculation of each Management’s Adjustment, if material; and
- the estimated time frame for achieving the synergies and dis-synergies of each Management’s Adjustment.

Forward-Looking Information

The SEC added an instruction in the amended rules indicating that Management’s Adjustments are expressly covered by the safe harbors for forward-looking information.

After Acquired Business Financials Included in Acquiror Financials

The SEC's May 20, 2020 release allows an acquiror to omit Target Historical Financials from registration and proxy statements:

- once target financials have been reflected in the acquiror's financials for:
  - 9 months (instead of a complete fiscal year) if the acquisition is ≤ 40% significant
  - a complete fiscal year if the acquisition is > 40% significant
- if the Target Historical Financials were not previously filed, even if the target is of "major significance" (as previously required)

Using Pro Forma Financials to Calculate Significance

Under the amended rules, in calculating the significance tests to determine whether/what Acquired Business Financials are required to be included in a registration or proxy statement, an acquiror can use filed pro forma financial information (instead of the acquiror's historical financials) if:

- the acquiror has already filed Acquired Business Financials (including Target Historical Financials and Pro Forma Financials);
- the pro formas only reflect adjustments for significant business acquisitions and dispositions that closed after the acquiror's most recent fiscal year end;
- the adjustments made in the pro formas are limited to combining the historical financial information of the acquiror and the targets and "Transaction Accounting Adjustments" (adjustments to account for the transaction---discussed further below under "Pro Forma Financials");
- the pro formas do not give effect to "Autonomous Entity Adjustments" (adjustments necessary to reflect the operations and financial position of the acquiror as an autonomous entity when the acquiror was previously part of another entity -- discussed further below under "Pro Forma Financials");
- the pro formas do not give effect to "Management's Adjustments" (synergies and dis-synergies identified by management in determining to consummate or integrate the transaction for which pro forma effect is being given and insight to investors into the potential effects of the acquisition and the post-acquisition plans expected to be taken by management --- discussed further below under "Pro Forma Financials"); and
- the pro formas do not give effect to any other transactions, such as the use of proceeds from an offering.

If an acquiror decides to use pro forma financial information (instead of the acquiror's historical financials) in calculating significance, it must continue to do so until it files its next annual report on Form 10-K / 20-F.

Individually Insignificant Acquisitions → Significant in the Aggregate

Even if an individual acquisition is not more than 20% significant to an acquiror, the SEC clarified in its May 20, 2020 release that the acquiror is still required to include Acquired Business Financials (including Target Historical Financials covering at least the substantial majority of the acquired businesses and Pro Forma Financials reflecting the aggregate effects of all individually insignificant businesses in all material respects) in a registration or proxy statement if the aggregate impact of all individually insignificant businesses acquired by the acquiror since the date of its most recently audited balance sheet is more than 50% significant to the acquiror.

In its May 20, 2020 release, the SEC clarified that the individually insignificant acquisitions that must be included in this calculation are:

- any acquisition that closed after the acquiror's last audited balance sheet date that was ≤ 20% significant to the acquiror;
- any probable acquisition whose significance to the acquiror < 50%; and
- any consummated acquisition with significance > 20% but ≤ 50% and the registration / proxy statement will be filed before the 75-day deadline to file Acquired Business Financials.

In aggregating individually insignificant acquisitions for the purpose of calculating significance under the income test, the SEC indicated that businesses reporting losses should be aggregated separately from businesses reporting income, and if either group is more than 50% significant to the acquiror, both groups should be included in the disclosure.

Acquiring Part of a Company

Abbreviated Audited Historical Financial Statements

If an acquiror acquires a part of a company (not the whole company), such as a product line or line of business, and it constitutes a "business" (as defined in Article 11 of Regulation S-X), the SEC amended its disclosure rules to allow the acquiror to file abbreviated audited financial statements of the acquired business since it may be impracticable for the acquiror to file full financial statements.

For an acquiror to qualify to file abbreviated audited financial statements of an acquired business:

- the total assets and total revenues of the acquired business must be ≤ 20% of the consolidated total assets and total revenues of the seller (as of and for the most recently completed fiscal year);
- the acquired business cannot have been a separate entity, subsidiary, operating segment (as defined in US GAAP or IFRS, as applicable), or division of the seller during the periods for which acquired business financial statements would be required;
- separate financial statements for the business cannot have been previously prepared; and
- the seller cannot have maintained the distinct and separate accounts necessary to present full financial statements for the acquired business and it must be impracticable for the seller to prepare such financial statements.

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Acquiring Part of a Company (Continued)

What Must Be Included in Abbreviated Historical Financials?

The audited abbreviated financial statements of the acquired business must include:

- **Balance Sheet:** a statement of assets acquired and liabilities assumed
- **Income Statement:**
  - a statement of revenues and expenses
  - corporate overhead expenses can be excluded, except the acquiror cannot omit pre-acquisition selling, distribution, marketing, general and administrative, and research and development expenses incurred by or on behalf of the acquired business
  - interest expenses can be excluded, except the acquiror can only exclude interest expense if the debt to which the interest expense relates will not be assumed by the acquiror
  - income tax expenses can be excluded
  - the cost of sales or services and depreciation and amortization expense are examples of expenses, among others, that must be included
  - the title of the income statement must indicate that it omits certain expenses
- **Notes to Financials** including:
  - the type of omitted expenses and the reason(s) why they are excluded from the financial statements
  - an explanation of the impracticability of preparing financial statements that include the omitted expenses
  - a description of how the financial statements presented are not indicative of the financial condition or results of operations of the target going forward because of the omitted expenses
  - information about the target's operating, investing and financing cash flows, to the extent available.

Additional Considerations

Furnished vs. Filed

The SEC required acquirors to file (not furnish) Acquired Business Financials. Filings that are "furnished" (not "filed") with the SEC are exempt from many (but not all) of the liability provisions under the Exchange Act of 1934 so the distinction is meaningful. In addition, information that is "furnished" (not "filed") with the SEC is not automatically incorporated by reference into registration statements or other SEC filings.

Equity Method vs. Fair Value Option Accounting for Acquisitions

The SEC also clarified in its May 20, 2020 release that:

- *Equity Method:* If an acquiror uses the equity method to account for an acquisition, it should file the post-acquisition summarized financial information or separate financial statements of the target required by Rules 3-09 and 4-08(g) of Regulation S-X (and not Acquired Business Financials)
- *Fair Value Option*: If an acquiror uses the fair value option method to account for an acquisition, it should file Acquired Business Financials

Financial Statement Schedules

The SEC noted in its May 20, 2020 release that Acquired Business Financials do not need to include any schedules required by Article 12 of Regulation S-X.

Foreign Acquired Businesses / IFRS

IFRS Reconciliation. Acquirors that are foreign private issuers and prepare their financial statements in accordance with IFRS will be permitted under the amended rules to reconcile Target Historical Financials to IFRS (instead of US GAAP), but:

- the reconciliation will be required to be in accordance with IFRS 1 (First-time Adoption of IFRS); and
- Form 20-F accommodations that are inconsistent with IFRS (such as not removing the effects of inflation accounting when the conditions of IAS 29 are not met or not reconciling the effects of proportionate consolidation in joint ventures) will not be available when reconciling Target Historical Financials to IFRS.

IFRS Preparation. In addition, under the amended rules, an acquiror can file Target Historical Financials that were prepared in IFRS (without a US GAAP reconciliation) so long as the target would qualify as a foreign private issuer if it was an SEC reporting company, regardless of whether the acquiror prepares its financial statements in accordance with IFRS or US GAAP. If the acquiror's financials are prepared in accordance with US GAAP and the Target Historical Financials are prepared in accordance with IFRS, the acquiror must prepare the Pro Forma Financials in accordance with US GAAP.

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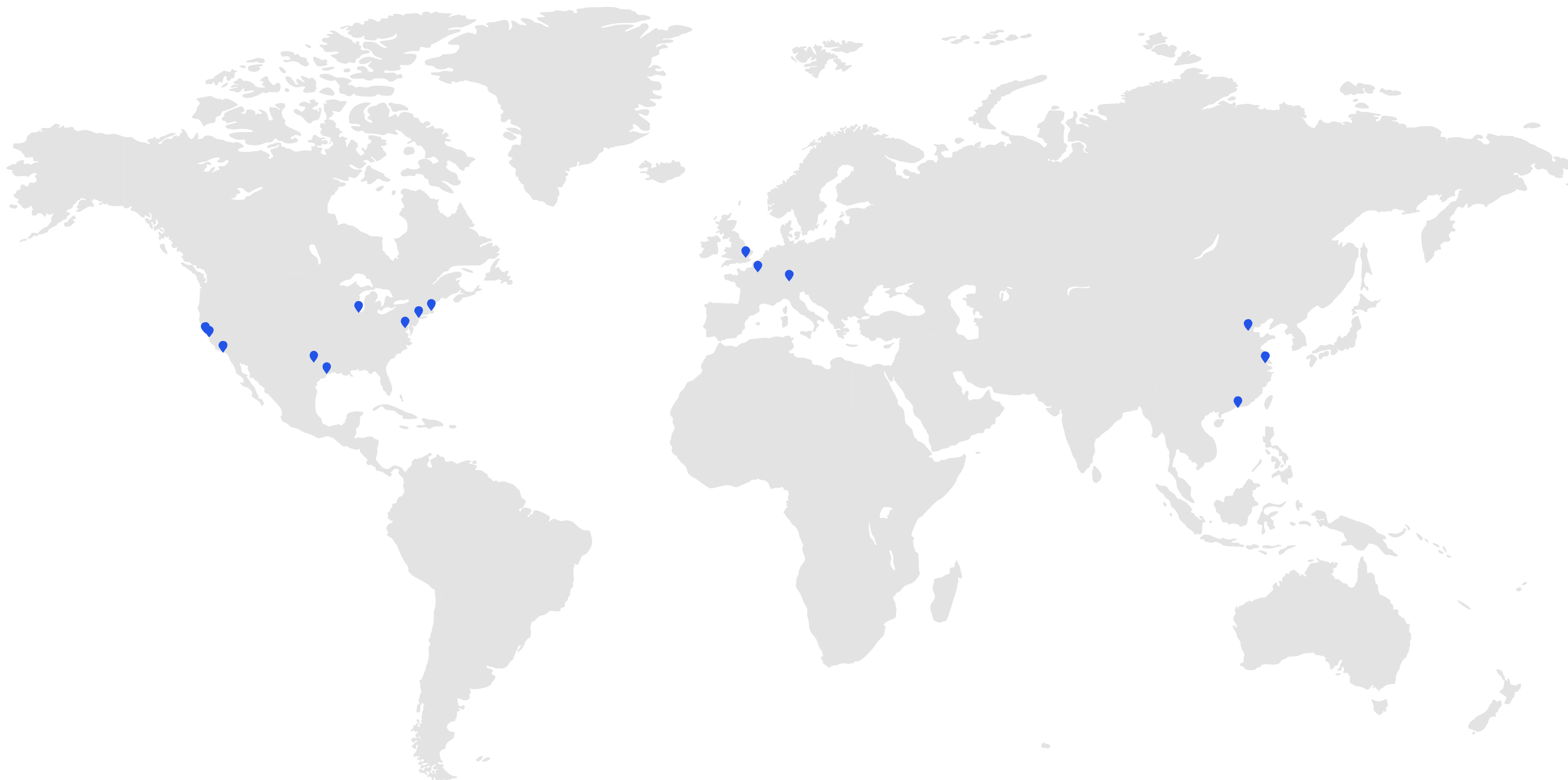
International Reach



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