

CLIENT BRIEF | SEC Proposes Changes to Financial Disclosures for Acquisitions

May 15, 2019 | Earlier this month, the U.S. Securities and Exchange Commission proposed amendments to the rules governing financial statement disclosures for business acquisitions and dispositions. The proposed amendments are intended to reduce the cost and burden of preparing historical statements and pro forma financial information in connection with acquisitions or other business combinations for public companies.

The proposal amends Rule 3-05 (relating to historical financial statements) and Article 11 of Regulation S-X (relating to pro forma financial information). The proposal, if adopted, would:

- Update the “significance” tests used to determine whether acquisitions or dispositions require disclosure
- Reduce the number of periods for which significant information must be presented
- Eliminate requirement for financial statements for targets carved from broader entities and which did not maintain separate financial statements
- Revise requirements when pro forma financial information is required for acquisitions
- Provide relief for first-time registrants regarding financial statements for acquired companies
- Clarify new rules relating to financial disclosures by investment companies for fund acquisitions

Changes to the Significance Tests

Currently, three tests are used to determine whether an acquisition is significant: (i) size of acquirer’s investment in target vs. total assets of acquirer; (ii) pre-tax income of target vs. pre-tax income of acquirer; and (iii) assets of target vs. assets of acquirer. The proposed rules would change the investment and income tests as follows:

- *Investment Test*
The denominator of the investment test (assets of acquirer) would be changed from measuring assets to measuring worldwide market value, calculated by the acquirer’s stock price on the last business day of the preceding fiscal year. The numerator would be changed to include the fair value of certain contingent considerations being given in the transaction.
- *Income Test*
If an acquirer’s income for the past fiscal year is 10% or more below its five-year average, acquirer may use the five-year average number in the numerator; after-tax income will be used instead of pre-tax income; and two different calculations must *both* be exceeded to meet the test: (i) target income/acquirer income; and (ii) target revenue/acquirer revenue.

The proposed rules also would permit first-time registrants to use pro forma financial information in the denominator of both the investment and income tests.

Financial Statements for Partial Entities

In many cases, a target is not a separate company but rather a division of a larger entity, so financial information is not separated from broader results. In those cases, the preparation of separate financial statements for the target business to satisfy the SEC disclosure requirements can be unduly costly or burdensome. Therefore, the proposed amendments, which provide for more limited financial statements of target businesses, will be a welcomed change.

Pro Forma Financial Information

The current pro forma disclosure requirements permit only limited adjustments in presentation by the acquirer. The proposed rules relax this requirement and permit two new categories of adjustments:

- Adjustments to reflect the application of required accounting rules; and
- Adjustments by acquirer's management to reflect expected synergies and other effects of the transaction so long as they are reasonably estimable and reasonably expected to occur.

Registrants should be mindful that this could potentially increase exposure to liability for forward-looking information and, should the rules be adopted, registrants should take that into account when preparing such adjustments.

Conclusion

The proposed rules reflect a thoughtful step in reducing the burdens on public acquirers by eliminating the need for certain, immaterial information while still providing investors with material information. SEC Chairman Jay Clayton commented in the release: "The staff's work on the proposed rule amendments reflects years of experience. Their work to eliminate unnecessary costs and burdens of the current rules — which in some cases have been significant and frustrated otherwise attractive transactions — while at the same time improving the disclosures investors receive should be applauded."

The comment period runs through early July, and we expect to see final action by Fall 2019.

Resources

SEC Fact Sheet: <https://www.sec.gov/news/press-release/2019-65>

Full Release: <https://www.sec.gov/rules/proposed/2019/33-10635.pdf>

For more information about the proposed changes to financial disclosures for acquisitions, please contact Geoff Morgan or Jessica Fairchild.

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