Milbank

European Leveraged Finance and Capital Markets Group

Client Alert

The SEC Adopts Amendments to Financial Disclosures About Acquired and Disposed Businesses

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On May 21, 2020, the Securities and Exchange Commission ("**SEC**") announced that it has adopted certain amendments (the "**Final Amendments**") to the financial disclosure requirements in Regulation S-X for acquisitions and dispositions of businesses, as well as in related rules and forms. The Final Amendments update the rules which have not been comprehensively addressed since their adoption over 30 years ago. The Final Amendments will, among other changes:

- revise the significance tests used to determine the significance of acquisitions and dispositions, by introducing the concept of aggregate worldwide market value to the investment test, adding a revenue component to the income test and raising the significance threshold for dispositions to 20%;

- require the financial statements of an acquired business to cover no more than the two most recent fiscal years;

- eliminate the requirement for historical financial statements for acquired businesses not exceeding the 20% significance where the aggregate impact of individually insignificant businesses exceed the 50% significance level and expand the pro forma financial information requirement to depict the aggregate effect of all individually insignificant businesses in all material respects;

- no longer require separate financial statements of an acquired business once the business has been included in the reporting company's post-acquisition financial statements for nine months (where one year of financial statements is otherwise required) or a complete fiscal year (where two years of financial statements are otherwise required);

- permit disclosure of financial statements that omit certain expenses for certain acquisitions of a component of an entity;

- amend the pro forma financial information requirements to provide for:

- “Transaction Accounting Adjustments” reflecting only the application of required accounting to the transaction;

- “Autonomous Entity Adjustments” reflecting the operations and financial position of the reporting company as an autonomous entity if the reporting company was previously part of another entity; and

- optional “Management’s Adjustments” depicting synergies and dis-synergies of the acquisitions and dispositions for which pro forma effect is being given if, in management’s opinion, such adjustments would enhance an understanding of the pro forma effects of the transaction and certain conditions related to the basis and the form of presentation are met.

The Final Amendments will be effective January 1, 2021. However, voluntary compliance with the Final Amendments will be permitted in advance of the effective date if they are applied in their entirety.

In the summary below, we discuss some of the key points in the SEC’s adopting release.

1. Significance Tests

Pre-Amendment

The SEC employs three different tests to determine the significance of an acquisition or a disposition:

- Investment test
- Asset test
- Income test

The table below summarizes these tests before the Final Amendments:

INVESTMENT TEST	ASSET TEST	INCOME TEST
Numerator: Investments in and advances to Target	Numerator: Proportionate share of total assets of Target (after intercompany eliminations)	Numerator: Equity in pre-tax Income from continuing operations of Target (exclusive of amounts attributable to any noncontrolling interests)
Denominator: Total assets of Reporting Company	Denominator: Total assets of Reporting Company	Denominator: Pre-tax Income from continuing operations of Reporting Company

Post-Amendment

The SEC has adopted amendments to the investment test and the income test, as described in detail below. The pre-amendment and post-amendment tests are compared in Annex A to this Client Alert.

Investment Test

Aggregate Worldwide Market Value

The denominator of the investment test for the purpose of acquisitions and dispositions will be the aggregate worldwide market value of the reporting company’s voting and non-voting common equity, when it is available. When it is not available, as in the case of private companies, the existing test using the total assets of the reporting company as the denominator will apply.

This amendment is intended to address a measurement mismatch in the pre-amendment rules, under which the numerator of the investment test is generally consistent with fair value, while the denominator is measured at book value. Post-amendment, both the numerator and the denominator will be generally consistent with fair value.

To moderate the daily variability, the aggregate worldwide market value to be used in the investment test will be the average of such value calculated daily for the last five trading days of the reporting company's most recently completed month ending prior to the earlier of the reporting company's announcement date or agreement date of the acquisition or disposition.

Contingent Consideration

The SEC has clarified in the Final Amendments that "investments in" the target will include the fair value of contingent consideration if required to be recognized at fair value by the reporting company at the acquisition date under U.S. GAAP or IFRS-IASB, as applicable. If recognition at fair value is not required, however, it must include all contingent consideration (including sales-based milestones and royalties, which the SEC had excluded from its originally proposed amendments), except contingent consideration for which the likelihood of payment is remote. The SEC believes that inclusion of contingent consideration provides a more accurate measure of an acquired business's relative significance.

In the Final Amendments, the SEC declined to permit the reporting company to determine significance of an acquisition using the fair value of the contingent consideration arrangement when fair value is not required by U.S. GAAP or IFRS-IASB, noting that the standard it is adopting is one employed in practice today, and that, under Rule 3-13, the SEC has the power to permit the omission of financial statements where it is consistent with the protection of investors.

The SEC has made the corresponding clarification with respect to dispositions.

The SEC has also clarified that, for acquisitions, "investments in" the target will mean the consideration transferred, adjusted to exclude the reporting company's and its subsidiaries' proportionate interest in the carrying value of assets transferred by the reporting company and its consolidated subsidiaries to the target that will remain with the combined entity after the acquisition.

Net Book Value to Test Combination of Entities or Businesses under Common Control

The SEC has adopted net book value as the metric to determine whether the investment test is met for a combination between entities or businesses under common control. Under Rule 3-05 (applying the 20% significance threshold), the investment test will be met when either the net book value of the target exceeds 20% of the reporting company's and its subsidiaries' consolidated total assets or the number of common shares exchanged or to be exchanged by the reporting company exceeds 20% of its total common shares outstanding at the date the combination is initiated.

Income Test

Revenue Component

The SEC has added a new revenue component to the income test. The new revenue component compares a reporting company's and its other subsidiaries' proportionate share of the target's consolidated total revenues from continuing operations (after intercompany eliminations) to such consolidated total revenues of the reporting company for the most recently completed fiscal year.

This is intended to reduce the anomalous result that reporting companies with marginal or break-even net income or loss in a recent fiscal year may be more likely to have targets deemed significant. The revenue component only applies when both the reporting company and its consolidated subsidiaries and the target had material revenue in each of the two most recently completed fiscal years. When the revenue component applies, the target must meet both the revenue component

and the net income component to satisfy the income test, and significance will be determined by the lower of the revenue component and the net income component. When the revenue component does not apply, significance will be determined based on the net income component only.

Income Averaging and the Use of Absolute Values

The SEC clarified in the Final Amendments that the net income component of the income test will be calculated using absolute values. This is intended to mitigate the potential for misinterpretation that may result from inclusion of a negative amount in the computation.

In addition, the net income component of the income test will be based on the average of the absolute values for the last five fiscal years, if (i) the revenue component does not apply and (ii) the pre-tax income of the reporting company and its consolidated subsidiaries from continuing operations attributable to the controlling interests for the most recent fiscal year is at least 10% lower than the average of the absolute value of such amounts for the last five fiscal years.

2. Requirements for Financial Statements for Significant Acquisitions

Three Years No Longer Required

Until the adoption of the Final Amendments, the SEC required up to three years of audited financial statements of an acquired business, depending on the significance levels determined by the three tests. The SEC will only require up to two years of such financial statements (i.e., two years, where a significance test exceeds 40%, and one year, where a significance test exceeds 20%). The SEC has cited the limited utility of the third year of pre-acquisition financial statements as compared to the potentially significant cost of preparing and obtaining an audit of them.

No Prior Comparative Interim Period Required If Only One Year Required

The SEC has also adopted amendments to require financial statements for the "most recent" interim period, rather than "any" interim period, where a significance test exceeds 20% but none exceeds 40%, so that there is no need to provide a comparative interim period when only one year of audited financial statements are required.

Individually Insignificant Acquisitions

Until the adoption of the Final Amendments, the SEC required audited pre-acquisition financial statements covering at least a substantial majority of the businesses acquired, if the aggregate impact of individually insignificant businesses exceeds 50%. "Substantial majority" has been applied in practice to be the mathematical majority (i.e., businesses constituting more than 50% of the relevant test (investment, asset or income test) on which the businesses were determined to be significant in the aggregate. This created a burden of preparing financial statements for individually immaterial acquisitions.

Prior to the adoption of the Final Amendments, the SEC also only required pro forma financial information with respect to an acquisition for which target financial statements are required, which could result in pro forma financial information that did not fully depict the aggregate effect of the individually insignificant businesses.

To address the anomalies described above, the SEC will require pro forma financial information that depicts the aggregate effects of all individually insignificant businesses in all material respects. Furthermore, the SEC will only require pre-acquisition financial statements for those businesses whose individual significance exceeds 20%.

In addition to the above, the SEC has adopted certain calculation rules to determine whether the impact of individually insignificant businesses exceeds 50%:

- In determining whether the investment test exceeds 50%, the aggregate impact of any acquired or to be acquired real estate operations must be included; and

- In determining whether the income test (i.e., both the revenue component and the pre-tax net income from continuing operations component) exceeds 50%, the businesses reporting losses must be aggregated separately from those reporting income. If either group exceeds 50%, then pro forma financial information will be required for all businesses and will not be limited to either the businesses with losses or those with income.

The SEC has acknowledged concerns as to whether accountants will be able to provide negative assurance to underwriters on the 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. The SEC has recognized that, in some circumstances, accountants may need to perform additional work to be able to provide negative assurance, observing that the "reasonable investigation" and "reasonable care" defenses under the U.S. federal securities laws are fact-specific and depend on a variety of factors.

Summary of the Required Financial Statements

The table below summarizes the significance thresholds where an acquisition has occurred[1].

SIGNIFICANCE LEVELS	PRE-AMENDMENT REQUIRED FINANCIAL STATEMENTS	POST-AMENDMENT REQUIRED FINANCIAL STATEMENTS
Individual acquisition (or multiple acquisitions of related businesses) 20% significance or less	No separate financial statements required.	No separate financial statements required.
Individual acquisition (or multiple acquisitions of related businesses) greater than 20% significance but not greater than 40% significance	Audited financial statements for **the most recent fiscal year** of the target should be included. Unaudited interim financial statements for **any interim period (i.e., including the prior comparative interim period)** may also be needed, depending on timing.	Audited financial statements for **the most recent fiscal year** of the target should be included. Unaudited interim financial statements for **the most recent interim period (i.e., excluding the prior comparative interim period)** may also be needed, depending on timing.
Individual acquisition (or multiple acquisitions of related businesses) greater than 40% significance but not greater than 50% significance	Audited financial statements for **the two most recent fiscal years** of the target should be included. Unaudited interim financial statements for any interim period may also be needed, depending on timing.	Audited financial statements for **the two most recent fiscal years** of the target should be included. Unaudited interim financial statements for any interim period may also be needed, depending on timing.
Individual acquisition (or multiple acquisitions of related businesses) greater than 50% significance	Audited financial statements for **the three most recent fiscal years** of the target should be included. Unaudited interim financial statements for any interim period may also be needed, depending on timing.	

[1] The significance threshold is 50% where (i) an acquisition is probable or (ii) the date of the final prospectus or prospectus supplement relating to an offering is no more than 74 days after the consummation and the financial statements have not been filed.

Multiple acquisitions of unrelated businesses that are less than 20% significant individually, aggregating more than 50% significance on a combined basis	Audited financial statements for **the most recent fiscal year** should be included for covering a **substantial majority** of the businesses acquired even if they are individually insignificant (i.e. below the 20% significance level). Unaudited interim financial statements for any interim period may also be needed, depending on timing.	No separate financial statements required.

Omission of Certain Pre-Acquisition Financial Statements

The SEC has adopted amendments to allow the reporting company to omit pre-acquisition financial statements for businesses that exceed 20% but do not exceed 40% significance once they are included in its audited post-acquisition results for nine months. Where the significance exceeds 40% and two years of pre-acquisition financial statements are required, such financial statements may be omitted once they are included in the reporting company's post-acquisition results for a complete fiscal year.

Abbreviated Financial Statements for Acquisition of a Component of an Entity for which Separate Financial Statements Have Not Previously Been Prepared

In light of the fact that companies frequently acquire a component of an entity that does not constitute a separate entity, subsidiary or division (e.g., a product line or a line of business contained in more than one subsidiary of the selling entity), the SEC has adopted amendments to allow abbreviated financial statements in the form of statements of assets acquired and liabilities assumed (exclusive of corporate overhead, interest and income tax expenses) to be provided to satisfy the requirement to provide the financial statements of a target. The SEC has recognized that, in these circumstances, making relevant allocations of the selling entity's corporate overhead, interest, and income tax expenses necessary to provide the target financial statements may be impracticable.

In addition to the presentation requirements detailed in the Final Amendments, the use of abbreviated financial statements is subject to the following qualifying conditions:

- Total assets and total revenues (both after intercompany eliminations) of the acquired or to be acquired business constitute 20% or less of such corresponding amounts of the seller and its subsidiaries consolidated as of and for the most recently completed fiscal year;
- The acquired business was not a separate entity, subsidiary, operating segment (as defined in U.S. GAAP or IFRS-IASB, as applicable), or division during the periods for which the acquired business financial statements would be required;
- Separate financial statements for the business have not previously been prepared; and
- The seller has not maintained the distinct and separate accounts necessary to present financial statements that include the omitted expenses and it is impracticable to prepare such financial statements.

Financial Statements of a Business that Includes Oil and Gas Producing Activities

The SEC has adopted amendments to require that for a target that includes "significant oil- and gas-producing activities" (as defined in the FASB ASC Master Glossary), the target financial statements must include certain industry-specific disclosures specified in FASB ASC Topic 932 *Extractive Activities – Oil and Gas*, which may be presented as unaudited supplementary information for each full year of operations presented for the acquired business.

Where the target generates substantially all of its revenues from oil and gas producing activities, the SEC has also adopted amendments to allow the target financial statements to consist of only audited statements of revenues and expenses that exclude depreciation, depletion and amortization expense, corporate overhead expense, income taxes, and interest expense. This is in recognition of the fact that, often, this type of business represents a component of an entity, but does not constitute a separate subsidiary, operating segment or division for which separate financial statements exist and for which historical depreciation, depletion and amortization expense is likely not meaningful to an understanding of the potential effects of the target on the reporting company. The qualifying conditions for abbreviated financial statements described in "—*Abbreviated Financial Statements for Acquisition of a Component of an Entity for which Separate Financial Statements Have Not Previously Been Prepared*" above must be met.

Foreign Businesses

The SEC will permit foreign private issuers that prepare their financial statements using IFRS-IASB to reconcile the target financial statements of a "foreign business" prepared using home-country GAAP to IFRS-IASB rather than U.S. GAAP. This will provide more comparable information to investors, as such financial statements were previously required to be reconciled to U.S. GAAP.

The SEC also adopted amendments to address the situation where a business could qualify to be a "foreign private issuer" if it were an SEC registrant but not qualify to be a "foreign business" when it is acquired. While the two definitions share similarities, they are not identical. This resulted in circumstances where a target that did not meet the definition of a "foreign business" was not permitted to use financial statements prepared in accordance with IFRS-IASB even when those financial statements were readily available and even though the target would qualify to present IFRS-IASB financial statements without reconciling to U.S. GAAP if it were an SEC registrant (as it would qualify as a "foreign private issuer"). The Final Amendments address this situation by permitting target financial statements to be prepared in accordance with IFRS-IASB without reconciliation to U.S. GAAP if the target would qualify as a foreign private issuer if it were an SEC registrant.

3. Pro Forma Financial Information

Article 11 of Regulation S-X ("**Article 11**") will continue to require pro forma financial information to be furnished under certain circumstances, including when an acquired business exceeds 20% on any of the significance tests described above (or 10% for acquired real estate operations). The pro forma financial information is intended to reflect the impact of the relevant transactions on the reporting company's financial position and income from continuing operations.

A. Adjustment Criteria and Presentation Requirements

Pre-Amendment

Article 11 in its pre-amendment form provides that the only adjustments that are appropriate in the presentation of the pro forma income statement and balance sheet are those that are directly attributable to the relevant transaction and factually supportable. Additionally, in the case of the pro forma income statement, the adjustments must be expected to have a continuing impact on the reporting company.

The SEC has noted that these criteria are not clearly defined, can lead to inconsistent presentation of similar fact patterns and preclude the inclusion of adjustments for potential post-acquisition effects (e.g., synergies).

Post-Amendment

The SEC has therefore adopted amendments to Article 11 with the aim of simplifying its requirements. The principal amendment to Article 11 is the replacement of the existing adjustment criteria with three categories of adjustments:

- ***Transaction Accounting Adjustments (required):*** these adjustments reflect the application of required accounting to illustrate the effects of the relevant transaction to the reporting company's historical balance sheet (assuming the transaction occurred on the balance sheet date) and income statement (assuming the transaction occurred at the beginning of the relevant period presented).

- ***Autonomous Entity Adjustments (required if applicable):*** these adjustments are required under Rule 11-01(a)(7) if the reporting company was previously part of another entity and the presentation of such adjustments is necessary to reflect the operations and financial position of the reporting company as an autonomous entity.

- ***Management's Adjustments (optional):*** management may include these adjustments to enhance investors' understanding of the expected effects, including identified synergies and dis-synergies, of the relevant transaction and management's planned actions following the transactions.

To the extent included in the pro forma financial information, Autonomous Entity Adjustments must be presented in a separate column from the Transaction Accounting Adjustments, and Management's Adjustments must be presented in the explanatory notes section (along with reconciliations of pro forma net income from continuing operations attributable to controlling interests and the related pro forma earnings per share data to such amounts after giving effect to Management's Adjustments).

The SEC has clarified that pro forma financial information must be appropriately labeled and presented, requiring that each transaction be presented in a separate column and generally prohibiting disclosure of (a) pro forma financial information on the face of the historical financial statements (except where specifically required by U.S. GAAP or IFRS-IASB), (b) summaries of pro forma financial information that exclude material transactions, (c) pro forma amounts that reflect Management's Adjustments without also presenting with equal or greater prominence the amounts to which they are required to be reconciled and a cross-reference to such reconciliation and (d) pro forma effect to the adoption of accounting standards. SEC also adopted various other amendments to simplify and clarify Article 11 and ensure more consistent use of terminology.

The SEC had initially proposed requiring more line-item specificity and a one-year time horizon for Management's Adjustments but was persuaded not to include these requirements in the Final Amendments as they would not necessarily correspond to the way synergy estimates are made and synergies do not have the same level of importance in all transactions.

Basis for Management's Adjustments

Under the Final Amendments, Management's Adjustments that are included in pro forma financial information must meet the following criteria (in addition to more technical requirements not described in this Client Alert):

- there is a reasonable for each such adjustment;

- for purposes of the pro forma income statement, (a) the adjustments are limited to the effect of synergies and dis-synergies on the historical income statement as if they existed as of the beginning of the relevant period presented and (b) if such adjustments reduce expenses, the reduction shall not exceed the amount of the related expense historically incurred during the relevant period presented; and

- the pro forma financial information reflects all Management's Adjustments that are, in the opinion of management, necessary to provide a fair statement of the pro forma financial information presented and a statement to that effect is disclosed and when synergies are presented, any related dis-synergies are also presented.

The explanatory notes must also describe the basis for and material limitations of each Management's Adjustment, including any material assumptions or uncertainties of such adjustment, explain the method of calculating the adjustment (if material) and disclose the estimated time frame for achieving the synergies and dis-synergies of such adjustment.

Notably, the SEC encourages the use of Management's Adjustments that meet the above requirements and considers that disclosing Management's Adjustments as part of pro forma financial information would more fully demonstrate to investors how historical amounts could change based on the relevant transaction.

The SEC acknowledges that Management's Adjustments may contain forward-looking information and to address concerns raised by commenters regarding the scope of liability applicable to such information, the Final Amendments clarify that the existing safe harbor provisions (Rule 175 and Rule 3b-6) are available for any forward-looking information included in Management's Adjustments.

B. Significance and Business Dispositions

Pre-Amendment

The pre-amendment rules provide that pro forma financial information is required upon the disposition or probable disposition of a significant portion of a business, if that disposition is not fully reflected in the financial statements of the reporting company. A disposition of a business is significant if the business to be disposed of meets any of the significance tests described above, using a 10% significance threshold, rather than the 20% threshold used for acquisitions.

Post-Amendment

The Final Amendments raise the significance thresholds for business dispositions from 10% to 20% and to conform, to the extent applicable, the tests used to determine significance of a disposed business to those used to determine the significance of an acquired business. These amendments also apply to dispositions of real estate operations, with some exceptions.

4. Other Amendments

The SEC's adopting release for the Final Amendments contains several other rule changes affecting, among other requirements, financial statements of real estate operations, disclosures about acquisitions specific to investment companies, disclosures by smaller reporting companies and issuers relying on Regulation A and various technical and clarificatory amendments not detailed in this Client Alert.

Appendix A

Comparison of the Significance Tests Pre-Amendment and Post-Amendment

	INVESTMENT TEST	ASSET TEST	INCOME TEST
Pre-Amendment	Numerator: Investments in and advances to Target Denominator: Total assets of Reporting Company	Numerator: Proportionate share of total assets of Target (after intercompany eliminations) Denominator: Total assets of Reporting Company	Numerator: Equity in pre-tax Income from continuing operations of Target (exclusive of amounts attributable to any noncontrolling interests) Denominator: Pre-tax Income from continuing operations of Reporting Company
Post-Amendment	**For all acquisitions (other than a combination between entities or businesses under common control) and dispositions:** Numerator: Investments in and advances to Target Denominator: Aggregate worldwide market value of the voting and non-voting common equity of Reporting Company (if worldwide market value exists) or total assets of Reporting Company (if worldwide market value does not exist) **For a combination between entities or businesses under common control:** Numerator: Net book value of Target Denominator: Total assets of Reporting Company and Numerator: Number of common shares exchanged or to be exchanged by Reporting Company Denominator: Total common shares of Acquired Company outstanding at the date the combination is initiated	Numerator: Proportionate share of total assets of Target (after intercompany eliminations) Denominator: Total assets of Reporting Company	Lower of the revenue component (if applicable) and the net income component, where: **Revenue component** Numerator: Proportionate share in the target's total revenues from continuing operations (after intercompany eliminations) Denominator: Total assets of Reporting Company **Net income component** Numerator: Equity in pre-tax Income from continuing operations of Target attributable to the controlling interests Denominator: Pre-tax Income from continuing operations of Reporting Company

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