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LAURA ANTHONY, ESQ.
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SEC Adopts Amendments to Disclosures Related to Acquisitions and Dispositions of Businesses

One year after proposing amendments to the financial statements and other disclosure requirements related to the acquisitions and dispositions of businesses, in May 2020 the SEC adopted final amendments (see here for my blog on the proposed amendments HERE). The amendments involved a long process; years earlier, in September 2015, the SEC issued a request for public comment related to disclosure requirements for entities other than the reporting company itself, including subsidiaries, acquired businesses, issuers of guaranteed securities and affiliates, which was the first step culminating in the final rules (see HERE).

The amendments make changes to Rules 3-05 and 3-14, 8-04, 8-05, and 8-06 of Regulation S-x, as well as Article 11. The SEC also amended the significance tests in the "significant subsidiary" definition in Rule 1-02(w), Securities Act Rule 405, and Exchange Act Rule 12b-2. Like all recent disclosure changes, the proposed rules are designed to improve the information for investors while reducing complexity and compliance costs for reporting companies. The amendments also make several related conforming rule and form changes. The new amendments go into effect on January 1, 2021 but voluntary compliance is permitted immediately.

Introduction

When a company acquires a significant business, other than a real estate operation, Rule 3-05 of Regulation S-X generally requires the company to provide separate audited annual and unaudited interim pre-acquisition financial statements of that business. Similarly, Rule 3-14 requires a company to file financial statements with respect to a significant real estate acquisition. The number of years of financial information that must be provided depends on the relative significance of the acquisition to the company.

Article 11 requires a company to file unaudited pro forma financial information, including a balance sheet and income statements, relating to the acquisition or disposition of businesses. Pro forma financial information is intended to show how the acquisition or disposition might have affected those financial statements.

Form 8-K generally requires that the audited financial statements and pro forma financial information be filed in an amendment to the original transaction closing form 8-K within 71 days of that closing 8-K (i.e., 75 days from the closing). Where an acquisition or disposition is not significant, no separate audits or pro formas are required.

The final amendments will:

- update the significance tests under these rules by revising the investment test to compare the company's investments in and advances to the acquired or disposed of business to the company's worldwide market value;
- update the significance tests under these rules by revising the income test by adding a revenue component;
- expand the use of pro forma financial information in measuring significance;
- conform the significance threshold and tests for a disposed business;
- modify and enhance the required disclosure for the aggregate effects of acquisitions for which financial statements are not required by increasing the pro forma information related to the aggregated businesses and eliminating historical financial information for insignificant businesses;
- reduce the period of the financial statements of the acquired business from three years to the two most recent fiscal years;
- permit disclosure of financial statements that omit certain expenses for certain acquisitions of a component of an entity;
- permit the use in certain circumstances of, or reconciliation to, International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB);

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- no longer require separate acquired business financial statements once the business has been included in the company's post-acquisition financial statements for nine months or a complete fiscal year, depending on significance;
- align Rule 3-14 with Rule 3-05 where no unique industry considerations exist;
- clarify the application of Rule 3-14 regarding the determination of significance, the need for interim income statements, special provisions for blind pool offerings, and the scope of the rule's requirements;
- amend the pro forma financial information requirements to include disclosure of "Transaction Accounting Adjustments," reflecting the accounting for the transaction; "Autonomous Entity Adjustments," reflecting the operations and financial position of a company as autonomous where it was previously part of another entity; and "Management's Adjustments," reflecting reasonably estimable synergies and transaction effects;
- make corresponding changes to the smaller reporting company and Regulation A requirements in Article 8 of Regulation S-X;
- add a definition of significant subsidiary that is tailored for investment companies; and
- add a new Rule 6-11 and amend Form N-14 to cover financial reporting for fund acquisitions by investment companies and business development companies.

The rules related to disclosures for the acquisitions and dispositions of businesses are complex and involve a significant accounting analysis. While accounting should be left to the accountants, legal advisors must be able to apply a fundamental working knowledge of the requirements so as to assist client companies make informed business decisions regarding the acquisition or disposition of a business.

Rules 3-05 and 8-04 of Regulation S-X – Financial Statements of Businesses Acquired or to Be Acquired

Summary of Current Rule

Rule 3-05 of Regulation S-X requires a reporting company to provide separate audited annual and reviewed stub period financial statements for any business that is being acquired if that business is significant to the company. A "business" can be acquired whether the transaction is fashioned as an asset or stock purchase. The question of whether it is an acquired "business" revolves around whether the revenue-producing activity of the target will remain generally the same after the acquisition. Accordingly, the purchase of revenue-producing assets will likely be treated as the purchase of a business.

In determining whether an acquired business is significant, a company must consider the investment, asset and income tests set out in Rule 1-02 of Regulation S-X. The "investment test" considers the value of investments in and advances to the acquired business relative to the value of the total assets of the company prior to the purchase. The "asset test" considers the total value of the assets of the company pre- and post-acquisition. The "income test" considers the change in income of the company as a result of the acquisition.

Rule 3-05 requires increased disclosure as the size of the acquisition, relative to the size of the reporting acquiring company, increases based on the investment, asset and income test results. If none of the test results exceed 20%, there is no separate financial statement reporting requirement as to the target company. If one of the tests exceeds 20% but none exceed 40%, Rule 3-05 requires separate target financial statements for the most recent fiscal year and any interim stub periods. If any Rule 3-05 text exceeds 40% but none exceed 50%, Rule 3-05 requires separate target financial statements for the most recent two fiscal years and any interim stub periods. When at least one Rule 3-05 test exceeds 50%, a third fiscal year of financial statements are required, except that smaller reporting and emerging growth companies are never required to add that third year.

Rule 8-04 is the sister rule to 3-05 for smaller reporting companies. Rule 8-04 is substantially similar to Rule 3-05 with the same investment, asset and income tests and same 20%, 40% and 50% thresholds. However, Rule 8-04 has some pared-down requirements, including, for example, that a third year of audited financial statements is never required where the registrant is a smaller reporting company.

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Both Rule 3-05 and 8-04 require pro forma financial statements. Pro forma financial statements are the most recent balance sheet and most recent annual and interim income statements, adjusted to show what such financial statements would look like if the acquisition had occurred at that earlier time.

An 8-K must be filed within 4 days of a business acquisition, disclosing the transaction. The Rule 3-05 or 8-04 financial statements must be filed within 75 days of the closing of the transaction via an amendment to the initial closing 8-K. Where the acquiring public reporting company is a shell company, the required Rule 8-04 financial statements must be included in that first initial 8-K filed within 4 days of the transaction closing (commonly referred to as a Super 8-K). By definition, a shell company would always be either an emerging growth or smaller reporting company and accordingly, the more extensive Rule 3-05 financial reporting requirements would not apply in that case.

The Rule 3-05 or Rule 8-04 financial statements are also required in a pre-closing registration statement filed to register the transaction shares or certain other pre-closing registration statements where the investment, asset or income tests exceed 50%. Likewise, the Rule 3-05 or Rule 8-04 financial statements are required to be included in pre-closing proxy or information statements filed under Section 14 of the Exchange Act seeking either shareholder approval of the transaction itself or corporate actions in advance of a transaction (such as a reverse split or name change). See my short blog HERE discussing pre-merger Schedule 14C financial statement requirements.

In what could be a difficult and expensive process for companies engaged in an acquisition growth model, if the aggregate impact of individually insignificant business acquisitions exceeds 50% of the investment, asset or income tests, Rule 3-05 or Rule 8-04 financial statements and pro forma financial statements must be included for at least the substantial majority of the individual acquired businesses.

Final Rule Change

The SEC has substantively revised the investment and income tests for non-investment companies and made non-substantive changes to the asset test. All three significance tests have been revised for investment companies. The final amendments also provide that, for acquisitions, intercompany transactions with the acquired business must be eliminated from the company's and its subsidiaries' consolidated total assets when computing the Asset Test.

Investment Test

The investment test compares the company's and its other subsidiaries' investments in (i.e., the purchase consideration paid) and advances to the tested subsidiary to the total assets of the company and its subsidiaries consolidated reflected at the end of the most recently completed fiscal year, or in the case of an acquired business, in the company's most recent annual financial statements required to be filed at or prior to the acquisition date.

The SEC has amended the investment test such that the company's investments in and advances to the acquired business will be compared to the aggregate worldwide market value of the company's voting and non-voting common equity when available. If the company does not have a worldwide market value, the existing test would still be used. The SEC believes that market value is a better parameter for determining the economic significance of an acquisition. I agree. Assets generally remain on the books at purchase price valuation, or are reduced for depreciation or amortization. For non-investment companies, assets are never marked up to fair value and, as such, can quickly become a stale indication of a company's current value.

The amendments specifically address when aggregate market value should be determined, provide instructions for determining investments and advances, including contingent consideration, and clarify the use of the test for related party transactions.

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Income Test

The income test compares the company's equity in the tested subsidiary's income from continuing operations before income taxes, including only income amounts contributed to the company's particular equity in the subsidiary (such as when the subsidiary is not wholly owned) to such income of the company for the most recently completed fiscal year.

The SEC has revised the income test by adding a revenue component and by using income or loss from continuing operations after income taxes (as opposed to before income taxes). This change will help account for factors that could distort income in a given year such as non-recurring expense items. In addition, the change will reduce the anomalous result of making an otherwise insignificant acquisition seem significant, where a company has marginal or break-even net income or loss in a year.

Under the amendment, where a company and the target have recurring revenue, both revenue and income should be tested. By revising the income test to require that the company exceed both the revenue and net income components when the revenue component applies, the SEC believes the test will more accurately determine whether a tested subsidiary is significant. If the company or the target does not have recurring revenue, only the net income test would be used.

In addition, the SEC has eliminated the requirement that three years of financial statements be provided for certain significant acquisitions and instead has capped the period at two years. The SEC has also revised Rule 3-05 for acquisitions where a significance test exceeds 20%, but none exceeds 40%, to require financial statements for the "most recent" interim period specified in Rule 3-01 and 3-02 rather than "any" interim period.

The final amendments also clarify that where a Form 10-K is filed after an acquisition closes but prior to the filing of the target financial statements, significance can be determined using either the last Form 10-K filed prior to the acquisition closing, or the newest Form 10-K filed after the closing. The final amendments also make various definition and word changes thought to more clearly and accurately reflect the implementation of the rules.

Asset Purchase

Where assets are purchased that constitute a business, but are not all of the assets or products of the seller, it can be difficult to create historical financial statements that only cover the sold assets. Accordingly, the SEC has amended the rules to permit companies to provide abbreviated audited financial statements including a balance sheet consisting of assets acquired and liabilities assumed, and statements of revenues and expenses (exclusive of corporate overhead, interest and income tax expenses) if: (i) the business constitutes less than 20% all of the assets and revenues of the seller, after eliminating intercompany transactions, as of the most recent fiscal year-end; (ii) the acquired business was not a separate entity, subsidiary, segment, or division during the periods for which the acquired business financial statements would be required; (iii) separate financial statements for the business have not previously been prepared; (iv) 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; (iv) interest expense may only be excluded if the corresponding debt will not be assumed; (v) the financial statements do not omit selling, distribution, marketing, general and administrative, research and development, or other expenses other than corporate overhead, interest in some cases, and income taxes, incurred by or on behalf of the acquired business during the periods to be presented; and (vi) the notes to financial statements include certain additional disclosures.

Foreign Business Acquisition

The SEC has modified Rule 3-05 to permit financial statements to be prepared in accordance with IFRS-IASB without reconciliation to U.S. GAAP if the acquired business would qualify to use IFRS-IASB if it were a registrant, and to permit foreign private issuers that prepare their financial statements using IFRS-IASB to provide Rule 3-05 financial statements prepared using home country GAAP to be reconciled to IFRS-IASB rather than U.S. GAAP.

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Smaller Reporting Companies and Regulation A Issuers

As mentioned above, Rule 8-04 is the sister rule to 3-05 for smaller reporting companies. Rule 8-04 is substantially similar to Rule 3-05 with the same investment, asset and income tests and same 20%, 40% and 50% thresholds. However, Rule 8-04 has some pared-down requirements, including, for example, that a third year of audited financial statements is never required where the company is a smaller reporting company. Regulation A issuers are permitted to follow Rule 8-04.

The SEC has revised Rule 8-04 such that smaller reporting companies would be directed to Rule 3-05 for the requirement 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 Article 8.

Additionally, under the amendments, a smaller reporting company is eligible to exclude acquired business financial statements from a registration statement if the business acquisition was consummated no more than 74 days prior to the date of the relevant final prospectus or prospectus supplement, rather than 74 days prior to the effective date of the registration statement as under the current rules.

Financial Statements in Registration Statements and Proxy Statements

Prior to the amendments, the rules could result in separate historical financial statements of the acquired business required to be included in registration statements and/or proxy statements after the closing of the acquisition and after SEC reports have been filed including the consolidated financial statements of the then combined entities. The amendment rule no longer requires Rule 3-05 financial statements in registration statements and proxy statements once the acquired business is reflected in filed post-acquisition company consolidated financial statements in certain circumstances.

Specifically, where an acquisition exceeds 20% but is less than 40% significance once financial statements are included in the company's audited post-acquisition consolidated financial statements for a period of at least nine months, separate financial statements will no longer need to be included in proxy or registration statements. Where an acquisition exceeds 40% significance once financial statements are included in the company's audited post-acquisition consolidated financial statements for a period of at least a complete fiscal year, separate financial statements will no longer need to be included in proxy or registration statements.

Individually Insignificant Acquisitions

If the aggregate impact of individually insignificant business acquisitions exceeds 50% of the investment, asset or income tests, Rule 3-05 or Rule 8-04 financial statements and pro forma financial statements must be included for at least the substantial majority of the individual acquired businesses. The rule amendments require disclosure if the aggregate impact of businesses acquired or to be acquired since the date of the most recent audited balance sheet filed for the company, exceeds 50%. Pro forma financial information is only required for those businesses whose individual significance exceeds 20% but are not yet required to file financial statements.

Use of Pro Forma Financial Information to Measure Significance

A company is generally permitted to use pro forma, rather than historical, financial information to test significance of a subsequently acquired business if the company made a significant acquisition after the latest fiscal year-end and filed its Rule 3-05 Financial Statements and pro forma financial information on Form 8-K as required. The amended rules continue to permit a company to use these pro forma financial statements and expands that ability to include pro forma financial information that only depicts significant business acquisitions and dispositions consummated after the latest fiscal year-end as long as such pro forma information has been filed in an 8-K or amended 8-K.

Rule 3-14 of Regulation S-X – Financial Statements of Real Estate Acquired or to Be Acquired

The SEC has historically believed that the real estate industry has distinct considerations. For example, audited financial statements for a real estate operation are rarely available from the seller without additional effort and expense because most real estate managers do not maintain their books on a U.S. GAAP basis or obtain audits. However, in reality the SEC had found that the differences between the financial statement materiality throughout the industries is much less significant than thought. As such, the SEC has amended the rules to more closely align the financial statement requirement of Rule 3-14 with Rule 3-05.

Article 11 – Pro Forma Financial Information

Article 11 of Regulation S-X details the pro forma financial statement requirements that must accompany both Rule 3-05 and 3-14 financial statements. Typically, pro forma financial information includes the most recent balance sheet and most recent annual and interim period income statements. Pro forma financial information for an acquired business is required at the 20% and 10% significance thresholds under Rule 3-05 and Rule 3-14, respectively. The rules also require pro forma financial information for a significant disposed business at a 10% significance threshold for all companies.

The SEC has revised the accounting adjustments made in preparation of the pro forma financial statements with the intent of simplifying the requirements and better reflecting the synergies of the transaction. The SEC amended Article 11 by replacing the existing pro forma adjustment criteria with simplified requirements to depict the accounting for the transaction and to provide the option to depict synergies and dis-synergies of the acquisitions and dispositions for which pro forma effect is being given.

The SEC also raised the pro forma financial statement requirement for a disposition from 10% to 20% based on significance testing. Rule 8-05 for smaller reporting companies and Regulation A issuers has been amended to align with the pro forma financial statement requirements in Article 11.

625 N. Flagler Drive, Ste, 600, West Palm Beach, FL 33401 • Toll Free: 1.800.341.2684
AnthonyPLLC.com • LAnthony@AnthonyPLLC.com

The Author

Laura Anthony, Esq.,
Founding Partner
Anthony L.G., PLLC | A Corporate Law Firm
LAnthony@AnthonyPLLC.com

Palm Beach securities attorney Laura Anthony and her experienced legal team provide ongoing corporate counsel to small and mid-size private companies, OTC and exchange traded public companies as well as private companies going public on the Nasdaq, NYSE American or over-the-counter market, such as the OTCQB and OTCQX. For more than two decades Anthony L.G., PLLC has served clients providing fast, personalized, cutting-edge legal service. The firm's focus includes, but is not limited to Regulation D and Regulation S and PIPE Transactions, securities token offerings and initial coin offerings, Regulation A/A+ offerings, as well as registration statements on Forms S-1, S-3, S-8 and merger registrations on Form S-4; compliance with the Securities Exchange Act of 1934, including registration on Form 10, reporting on Forms 10-Q, 10-K and 8-K, and 14C Information and 14A Proxy Statements; all forms of going public transactions; mergers and acquisitions including both reverse mergers and forward mergers; applications to and compliance with the corporate governance requirements of securities exchanges including Nasdaq and NYSE American. Palm Beach attorney Laura Anthony is also the author of SecuritiesLawBlog.com, the producer and host of LawCast.com, Corporate Finance in Focus, and a contributor to The Huffington Post and Law360.

Ms. Anthony is involved throughout the community of Palm Beach. She is on the board of directors for the American Red Cross for Palm Beach and Martin Counties, and provides financial support to the Susan Komen Foundation, Opportunity, Inc., New Hope Charities, the Society of the Four Arts, the Norton Museum of Art, Palm Beach County Zoo Society, the Kravis Center for the Performing Arts and several other organizations. She is also a financial and hands-on supporter of Palm Beach Day Academy, one of Palm Beach's oldest and most respected educational institutions. She currently resides in Palm Beach with her husband and daughter.

Ms. Anthony is an honors graduate from Florida State University College of Law and has been practicing law since 1993.

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