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SEC adopts amendments to financial disclosures about acquisitions and dispositions of businesses

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KPMG reports on the SEC's amendments[1] intended to improve financial information about business acquisitions and dispositions.

Applicability

Public companies, including foreign private issuers, registered investment companies and business development companies.

Facts and impacts

The SEC adopted amendments to requirements for companies to provide financial information relating to significant acquisitions and dispositions of businesses, and including real estate operations[2]. As part of the SEC's ongoing disclosure effectiveness project, the amendments aim to improve the financial information about acquired or disposed businesses for investors, facilitate more timely access to capital, and reduce the complexity and costs to prepare the disclosure.

In conjunction with these changes, amendments were made to the significance tests in the 'significant subsidiary' definition[3] to assist companies in making more meaningful determinations of whether a subsidiary, acquired or disposed business is significant. Additionally, significant modifications were made to the requirements related to the presentation of pro forma financial information. For financial statements of real estate operations, the amendments align Rule 3-14 with Rule 3-05 where no unique industry considerations exist. To address the unique attributes of investment companies and business development companies (collectively referred to as 'investment companies'), the SEC also adopted new requirements for these companies that previously analogized to existing rules. The SEC adopted conforming changes for smaller reporting companies, entities registered under Regulation A, foreign private issuers, and oil and gas companies.

Practice has developed for disclosures relating to acquired businesses based on guidance from the SEC staff (e.g. abbreviated financial statements for net assets that constitute a business and requirements for oil- and gas-producing activities). Companies have frequently sought relief under Rule 3-13 of Regulation S-X from certain aspects of the rules. The amendments codify many of those practice areas and current SEC staff guidance.

Background

When a company acquires a business or a real estate operation, it is generally required to provide annual and interim financial statements of the business or real estate operation, if significant. To determine significance,

[1] SEC Release No. 33-10786, Amendments to Financial Disclosures about Acquired and Disposed Businesses

[2] Rules 3-05, 3-14, 8-04, 8-05, 8-06, and Article 11 of Regulation S-X, as well as in other related rules and forms

[3] Rule 1-02(w) of Regulation S-X

the company applies the investment, asset and income tests using defined thresholds. The amended rules aim to improve and simplify the required significance tests by aligning and clarifying components of the rules and codifying current permissible practices.

Under Rule 3-05, a company that acquires a significant business, other than a real estate operation, is required to provide separate audited annual and unaudited interim pre-acquisition financial statements of that business. Recognizing that certain acquisitions have a greater impact on a company than others, Rule 3-05 addresses the reporting requirements for businesses acquired, or to be acquired, based on the 'significant subsidiary' definition in Rule 1-02(w) using a sliding scale approach. A company that has acquired, or proposes to acquire, a significant real estate operation similarly must file separate audited annual and unaudited interim abbreviated income statements with respect to such operations in compliance with Rule 3-14.

Article 11 of Regulation S-X requires pro forma financial information to be prepared for significant acquisitions and dispositions. Typically, pro forma financial information includes the most recent balance sheet and annual and interim income statements, and shows how the acquisition or disposition might have affected those financial statements if the transaction occurred at an earlier time. For example, pro forma financial information for a business acquisition combines the historical financial statements of the company and the acquired business, adjusted for certain items when specified criteria are met.

Investment companies often struggle with applying the current guidance due to their unique industry circumstances. For example, investment companies currently must apply all three tests of Rule 1-02(w) to assess significance of acquisitions. However, Rule 1-02(w) was not written for the specific characteristics of investment companies, and the requirement for investment companies to perform the asset test is generally not meaningful when applied to an investment company.

What stayed the same, and what changed?

Significance tests

Investment test

The investment test currently compares the investments in, and advances to, the acquired entity to the consolidated assets of the acquirer. So that companies are comparing the current fair value of both entities, the denominator is amended to be the acquiring company's (i.e. the registrant's) aggregate worldwide market value (AWMV) of its voting and non-voting equity, when available. Currently, companies use total assets, which does not always best represent the current value of the entity. When AWMV is not available, companies will continue to use total assets in this calculation.

The numerator of the test is meant to reflect the consideration paid for the entity, as determined under applicable generally accepted accounting principles (GAAP). It will also include all contingent consideration not required to be measured at fair value under applicable GAAP, unless payment is considered remote.

AWMV is calculated as an average. Companies will use their equity price for the last five trading days of the most recently completed month ending prior to the earlier of:

- the company's announcement date; or
- the agreement date of the acquisition or disposition.

Unlike the value used to determine filer status[4], the AWMV will also include equity held by affiliates. Additionally, by using an average nearer the acquisition date, the value is expected to more closely approximate the fair value of the acquirer before its acquisition.

This test will only be used for acquisitions and dispositions of businesses and real estate operations, and the existing test will be retained for use in all other tests of significant subsidiaries, e.g. when assessing for purposes of Rule 3-09.

Income test

The SEC adopted revisions to the income test that incorporate two components. One is the original income component and the second is a new revenue component. The traditional income test was retained substantially

[4] Exchange Act Rule 12b-2

in the same form, utilizing the absolute value of income or loss from continuing operations before taxes for both entities. By using absolute values, any confusion caused by having a negative percentage is removed.

The introduction of a revenue test is intended to reduce the number of anomalous results where an insignificant acquisition exceeds the income test significance threshold. This frequently occurs when an entity had near break-even results or large non-recurring income or expense in the year before acquisition. Current practice had developed where the SEC staff would consider revenue as a further indicator of significance when companies sought relief. The new test compares the acquirer's proportionate share of revenue of the tested subsidiary to its own consolidated total revenue for its most recently completed fiscal year. If the revenue test does not apply, because either entity does not have revenue, then only the income component will be considered.

The company will need to meet the minimum significance threshold for both tests to meet the income test, and will use the lower result from each component to determine the significance result for the test.

Example results		
Income component test result	**Revenue component test result**	**Significance result**
35% significance	**12% significance**	**Minimum significance threshold is not met.** No financial information is required because the revenue component is below 20%.
35% significance	50% significance	**Minimum significance threshold is met.** The company is required to present one year of financial information because the income component is between 20 and 40%.

While companies will continue to consider income averaging if their results meet the thresholds requiring an average to be calculated, averaging will be used only when the revenue component does not apply. In addition, when calculating an average, companies will no longer replace loss years with a zero because they will use the absolute value of losses incurred. This change in the averaging rules should also result in fewer acquisitions tripping significance thresholds.

Changes to the income test will be incorporated into Rule 1-02(w) and apply for all tests of significant subsidiaries. That is, the income and revenue components will both be used when assessing significance for other rules, such as Rules 3-09 or 4-08(g).

Asset test

While the asset test was not materially altered, the revisions will require intercompany transactions with the acquired business to be eliminated from the company's and its subsidiaries' consolidated total assets. These revisions also apply to the asset test calculated under any rule requiring that significance be calculated, such as Rule 4-08(g).

Significance tests using pro forma information

The revisions to the rules alter and expand the permission for companies to measure significance using filed pro forma financial information that only depicts significant business acquisitions and dispositions consummated after the latest fiscal year-end. Previously, the rules precluded companies filing initial registration statements from using pro forma information to measure significance. With the changes, the SEC intends for any company to be able to take advantage of this permission, subject to the following conditions:

— the registrant has filed Rule 3-05 or Rule 3-14 financial statements for any such acquired business; and
— the registrant has filed the pro forma financial information required by Article 11 for any such acquired or disposed business.

Companies filing initial registration statements will be considered to have met the requirements if this information is included in that registration statement.

Those companies taking advantage of this provision are required to continue to use pro forma financial information to measure significance until the next annual report on Form 10-K or Form 20-F. This codifies current practice.

Additionally, the pro forma financial information used in the significance tests can only include amounts that combine historical financial information of the company and the acquired business, as well as the new transaction accounting adjustment category of the pro forma information, described in further detail later in this publication.

Required information

Periods to be presented

At present, Rule 3-05 requires the presentation of up to three years of financial information of an acquired business. The amount of information required is based on certain defined thresholds applicable to acquisitions. In certain circumstances the information is required to be presented for a set cumulative period, even when the acquired entity has been incorporated into the company's historical financial information for a portion of the period. Full audited financial statements are required when significance is met; however, SEC guidance enables companies to seek relief under Rule 3-13, in certain circumstances, to provide more limited financial information.

With the amendments, the SEC has reduced the amount of information required to be provided, and enabled companies to determine when abbreviated financial statements might be appropriate without going through a waiver request process.

The thresholds for required information based on significance have been revised as follows.

Prior threshold	Revised threshold	Amended requirements
<20%	<20%	Not required.
>20% but <40%	>20% but <40%	1 year and most recent interim period. Comparative interim information is no longer required.
>40% but <50%	>40%	2 years and comparative interim periods.*
Individually insignificant acquisitions with aggregate impact >50%	Individually insignificant acquisitions with aggregate impact >50%	Provide audited financial statements for entities >20% individually significant and pro forma financial information depicting the aggregate effects of all such businesses in all material respects.

* The SEC has removed the category for greater than 50% significance that currently requires a third year of financial information. The concept of major significance was also removed with the adopted amendments.

Regardless of the thresholds stipulated above, if the omission of material disclosures would otherwise make the statements misleading, the company is required to present such material disclosures in accordance with Rule 4-01 of Regulation S-X.

Abbreviated financial statements

According to the adopted amendments, when a company acquires something less than all of the assets and liabilities of the seller, and

- the acquired business was not a separate entity, subsidiary, operating segment or division during the periods required to be presented;
- separate financial statements for the acquired business have not been prepared;
- the seller did not maintain the distinct and separate accounts necessary to present financial statements that include the omitted expenses; and
- it is impractical to prepare such financial statements,

that company will be permitted to present audited abbreviated financial statements without requesting relief under Rule 3-13 for its circumstances. These abbreviated financial statements include a statement of assets acquired and liabilities assumed, as well as a statement of revenues and expenses. The statement of revenue and expenses must include certain allocated expenses, while it may exclude others. For example, allocated expenses must include costs of sales or services, SG&A, distribution & marketing expenses, depreciation and amortization, but they may exclude corporate overhead allocations.

Registration statements

The amendments remove the requirement for separate acquired business financial statements that have not previously been filed to be provided once the business has been included in the company's post-acquisition audited annual financial statements for either nine months or a complete fiscal year, depending on significance. This amendment will also assist companies filing initial registration statements that had significant acquisitions during the periods presented.

Rule 3-14

Rule 3-14 has traditionally differed from Rule 3-05 in certain ways because unique industry considerations for real estate operations warranted differentiated disclosure. While significance of properties or real estate operations has not been defined in the SEC regulations, entities have historically used the investment test and a 10 percent threshold to consider significance under Rule 3-14. Different aggregation rules have also been used, with presentation requirements starting at lower thresholds than those used under Rule 3-05.

A new definition of a real estate operation is included in the amendments, which is "a business that generates substantially all of its revenues through the leasing of real property." The term 'substantially all' is not meant to be a bright line and therefore was not further defined by the SEC in the amendments. The application of the definition therefore will depend on specific facts and circumstances.

The amendments to Rule 3-14 were made with the intention of eliminating differences from Rule 3-05 when no unique industry considerations exist. The final amendments specify the use of the investment test, as modified for Rule 3-05, with one additional amendment. When using total assets as the denominator, the numerator for the investment test will be the company's investments in the real estate operations, including any debt secured by the real properties that is assumed by the company. In addition, the SEC has aligned the significance thresholds of Rule 3-14 with those of Rule 3-05, other than for acquisitions >40 percent but less than 50 percent, and eliminated the requirement to provide three years of financial statements for acquisitions of related parties. Further, Rule 3-14 will now explicitly require financial statements for the most recent year-to-date interim period prior to the acquisition. Rule 3-14 financial statements will be required in registration statements using the same timing requirements as Rule 3-05. Lastly, these financial statements may be omitted once the acquired real estate operation has been reflected in filed financial statements for nine months.

Blind pool offerings

The SEC codified current guidance for these entities, requiring significance to be computed by comparing the company's and its other subsidiaries' 'investments in' the real estate operation to the sum of the company's total assets as of the date of the acquisition; and the proceeds (net of commissions) in good faith expected to be raised in the registered offering over the next 12 months.

Pro forma financial information

Article 11 of Regulation S-X defines pro forma financial information, and specifies the circumstances under which it is required to be presented in SEC filings. These include requirements for when a company enters into significant acquisitions and dispositions of businesses, including real estate operations. If a company was previously part of another entity, pro forma financial information also may be required in a filing with the SEC to reflect the company's operations and financial position as a stand-alone entity.

The overall objective of pro forma information is to provide investors with information about the ongoing effect of a particular transaction by presenting how the transaction might have affected the historical financial statements of the company if consummated at an earlier date. Currently, pro forma adjustments to the balance sheet must be directly attributable to the transaction, and factually supportable. For income statement adjustments, they must additionally have a continuing impact. These requirements often preclude certain adjustments, including one-time adjustments, that some felt might be informative to investors and provide insight into the potential effects of the acquisition, post-acquisition plans expected to be taken by management and insights into management's decision to enter into the transaction.

The SEC adopted amendments to the pro forma adjustment criteria to both simplify and permit the depiction of synergies and dis-synergies of the transaction for which the pro forma information is provided.

Revised pro-forma adjustment criteria provide for:		
Transaction accounting adjustments	**Autonomous entity adjustments (when applicable)**	**Optional management adjustments***
Reflect the GAAP accounting for the transaction to illustrate the effects of the acquired business to the company's audited historical financial statements.	Reflect the operations and financial position of the company as an autonomous entity when the company was previously part of another entity.	Reflect forward-looking information that depicts the reasonably estimable synergies and other transaction effects that have occurred, or are reasonably expected to occur.
* These adjustments will be presented as explanatory notes to the pro forma financial information, in the form of reconciliations.		

Both transaction accounting and autonomous entity adjustments are required to the extent applicable. Management's adjustments may be presented if in management's opinion such adjustments would enhance an understanding of the pro forma effects of the transaction. Certain conditions must also be met in order to provide this presentation. These required conditions for presentation are:

— there is a reasonable basis for each adjustment;
— the adjustments are limited to the effect of such synergies and dis-synergies on the historical financial statements that form the basis for the pro forma statements as if they existed at the beginning of the fiscal year presented; and
— they reflect all management's adjustments that are, in the opinion of management, necessary to a fair statement of the pro forma financial information, and a statement to that effect is disclosed. A balanced presentation of both synergies and dis-synergies must be made.

Individual columns for different transactions will be required when pro forma information depicts multiple transactions.

KPMG observation

The conditions are intended to ensure that, when presented, management's adjustments reflect an appropriate view of the transaction so they are not misleading. A significant number of disclosures will be required in the explanatory notes to the pro forma financial information when these adjustments are presented. Additionally, management's adjustments may require updating in registration statements.

Determining management's adjustments will require making estimates and assumptions. These adjustments introduce further judgment into the pro forma financial statements, which will potentially make them less consistent across companies.

Investment companies

Significance tests

The SEC's amendments tailor the financial reporting requirements for investment companies with respect to their acquisitions of investment companies and other types of funds. The amendments add a definition of 'significant subsidiary' specifically tailored for investment companies that uses an investment and income test, and eliminates use of the asset test.

The amended investment test requires an assessment of whether the value of the acquirer's and its other subsidiaries' investments in and advances to the tested subsidiary exceed 10 percent of the value of the total investments of the acquirer and its subsidiaries consolidated as of the end of the most recently completed fiscal year. The previous test required a comparison to total assets.

The SEC amended the income test for investment companies to use the income test in Rule 8b-2, but modified it to include any net realized gains and losses and net change in unrealized gains and losses. A subsidiary would be deemed significant if the absolute value of the sum of combined investment income from dividends, interest, and other income, the net realized gains and losses on investments, and the net change in unrealized gains and losses on investments from the tested subsidiary for the most recently completed fiscal year exceeds:

— 80 percent of the absolute value of the change in net assets resulting from operations of the acquirer and its subsidiaries consolidated for the most recently completed fiscal year; or
— 10 percent of the absolute value of the change in net assets resulting from operations of the acquirer and its subsidiaries consolidated for the most recently completed fiscal year and the investment test condition exceeds 5 percent ('alternate income test'). However, if the absolute value of the change in net assets resulting from operations is at least 10 percent lower than the average of the absolute value of such amounts for each of the last five fiscal years, then the acquirer may compute both conditions of the income test using the average of the absolute value of such amounts for the acquirer and its subsidiaries consolidated for each of its last five fiscal years.

Required financial statements

Currently, there are no specific rules or requirements in Article 6 for investment companies relating to the financial statements of acquired funds. Instead, investment companies have generally applied the requirements of Rule 3-05, although it has often been unclear how to apply these reporting requirements in the context of acquired funds. A new Rule 6-11 has been adopted to address the financial disclosure obligations for acquired funds, including any investment company as defined in Section 3(a) of the Investment Company Act of 1940, including a business development company, or any company that would be an investment company but for the exclusions provided by sections 3(c)(1) or 3(c)(7) of that Act, or any private account managed by an investment adviser.

The new rule requires one year of audited financial statements for fund acquisitions and the related schedules specified in Article 12, a change from the existing Rule 3-05 requirements of between one and three years of audited financial statements. Acquisitions of a group of related funds would be considered as a single acquisition.

To determine whether financial statements of a fund acquired or to be acquired must be provided, the conditions specified in the definition of 'significant subsidiary' would be applied, using the investment test and the alternate income test and substituting 20 percent for 10 percent for each place it appears therein. If either of the tests were satisfied at the 20 percent condition, the company would be required to file the financial statements for the acquired fund. If the aggregate effect of individually insignificant funds acquired or to be acquired since the most recent audited balance sheet were to exceed the conditions of the investment test and the alternate income test, substituting 50 percent for 10 percent, then the company would be required to provide the financial statements for each individually insignificant fund and the supplemental financial information.

Pro forma financial information and supplemental financial information

Currently, Rule 11-01 requires an investment company to furnish pro forma financial information when a significant business acquisition has occurred or is probable. The amended rule eliminates the pro forma financial information requirement for investment companies and replaces it with a requirement for supplemental financial information that is more relevant to fund investors. The supplemental financial information would include:

— a pro forma fee table, setting forth the post-transaction fee structure of the combined entity;
— if the transaction will result in a material change in the acquired fund's investment portfolio due to investment restrictions, a schedule of investments of the acquired fund modified to show the effects of such change and accompanied by narrative disclosure describing the change; and

— narrative disclosure about material differences in accounting policies of the acquired fund when compared to the newly combined entity.

KPMG observation

The amendments should benefit both investment companies and their investors by providing industry standards to be consistently applied for determining the significance of fund acquisitions. The rules may more accurately identify acquisitions that are economically significant, and will benefit companies because they will not be required to prepare separate financial disclosure for economically insignificant acquisitions.

Foreign businesses

Amendments were made to certain requirements for foreign private issuers and acquisitions of foreign businesses. The revisions permit foreign private issuers that prepare their financial statements using IFRS® Standards as promulgated by the International Accounting Standards Board (the IASB® Board and collectively IFRS-IASB) to reconcile Rule 3-05 financial statements of foreign businesses prepared using home country GAAP to IFRS-IASB rather than US GAAP. The SEC believed that requiring a reconciliation to US GAAP was of little use to investors in these circumstances. The reconciliation to IFRS-IASB is required generally to follow the form and content requirements in Item 17(c) of Form 20-F.

Two further clarifying points were added for reconciliations to IFRS-IASB from home country GAAP. The first is that IFRS 1, First-time Adoption of IFRS Standards, is applicable, and the second is that the accommodations in Form 20-F that are inconsistent with IFRS-IASB are not available. Each clarification was made with the intention of maintaining consistency between these reconciliations and other preparers using IFRS-IASB.

Additionally, the changes to Rule 3-05 permit acquired entity financial statements to be prepared in accordance with IFRS-IASB without reconciliation to US GAAP if the acquired business would qualify as a foreign private issuer if it were a registrant. This permission should ease the burdens on companies that acquire foreign businesses that already have these financial statements prepared and facilitate certain cross-border transactions. The permission applies even for companies that prepare financial statements using US GAAP.

KPMG observation

The changes intend to improve disclosures and reduce the cost of preparing filings of foreign private issuers by allowing companies to present financial information for non-issuer entities on an IFRS-IASB basis or on a local GAAP basis reconciled to IFRS-IASB. However, Article 11 pro forma information will still require US GAAP presentation for acquirers that are reporting under US GAAP.

Smaller reporting companies and issuers relying on Regulation A

The rule also amended Rule 8-04, which directs smaller reporting companies to Rule 3-05 for significance testing and thresholds. Form and content requirements will continue to be prepared in accordance with Rules 8-02 and 8-03. As a result, under the amendments, smaller reporting companies will continue to be required to provide up to two years of financial statements. Because Part F/S of Form 1-A refers to Rule 8-04, the amendments to Rule 8-04 apply to issuers relying on Regulation A. Regulation A issuers will continue to be permitted to present the applicable periods.

This will also permit smaller reporting companies and issuers relying on Regulation A to omit historical acquired business financial statements if the acquired business has been included in the company's results for either nine months or a complete fiscal year, depending on significance.

Oil and gas producing activities

For a significant acquired business that includes significant oil- and gas-producing activities (as defined in the FASB ASC Master Glossary), Rule 3-05 financial statements must include certain ASC 932, Extractive Activities

– Oil and Gas, disclosures, which may be presented as unaudited supplementary information for each full year of operations presented for the acquired business. Additionally, Rule 3-05 financial statements may consist of only abbreviated audited financial statements when the acquired oil- and gas- producing business represents a component of an entity that does not constitute a separate entity, subsidiary, operating segment (as defined in US GAAP or IFRS Standards, as applicable), 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 acquired or to be acquired business on the company.

Effective dates

Issuers are required to comply with the final rule for:
Securities Act or Exchange Act registration statements beginning after December 31, 2020.
Initial registration statements are not required to apply the amendments until an initial registration statement is first filed on or after December 31, 2020.
Acquisitions and dispositions that are probable or consummated after December 31, 2020 must be evaluated for significance using the amendments.
Early adoption is permitted provided the amendments are applied in their entirety from the date of early adoption.

KPMG observation
For acquisitions and dispositions disclosed in Item 2.01 of Form 8-K before adoption, the company must file the financial statements and pro forma financial information required by current rules.

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KPMG's Financial Reporting View

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