



New Developments Summary

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SEC amends financial disclosures for business acquisitions and dispositions

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The SEC recently adopted the Final Rule, *Amendments to Financial Disclosures about Acquired and Disposed Businesses*, updating the disclosure requirements in Rules 3-05 and 3-14 as well as Article 11 under Regulation S-X. The amendments also update the significance tests in S-X Rule 1-02(w). The Final Rule is intended to reduce complexity and costs for preparers while providing improved disclosures to investors.

The Final Rule is effective January 1, 2021. Early compliance is permitted.

A. Overview

The [Final Rule](#) amends Regulation S-X, Rule 3-05, *Financial statements of businesses acquired or to be acquired*; Rule 3-14, *Special instructions for real estate operations to be acquired*; and Article 11, *Pro forma financial information*, as well as other related rules and forms. The Final Rule makes corresponding changes to the reporting requirements in S-X Article 8, *Financial statements of smaller reporting companies*. It also amends the “significant subsidiary” definition in S-X Rule 1-02(w), *Significant subsidiary*,¹ to update the investment and income tests and to facilitate more meaningful significance determinations.

Further, the amendments add a new rule to Regulation S-X S-X Rule 6-11, *Financial statements of funds acquired or to be acquired*, addresses unique financial reporting considerations for acquisitions made by investment companies, including business development companies (BDCs).

The Final Rule is effective for fiscal years beginning after December 31, 2020, with early compliance permitted.



Grant Thornton insight: Key amendments

There are several amendments under the Final Rule that are expected to reduce compliance burdens on registrants, while providing relevant and material information to investors, including

- Limiting the number of periods for which the financial statements of the acquired business are required.
- Amending significance tests to reduce instances yielding anomalous results.
- Permitting the filing of abbreviated financial statements, if certain conditions are met.

Amendments to pro forma financial information are expected to increase relevance to investors; however, certain adjustments will require significant judgment on the part of registrants.

B. Significance tests under S-X Rule 1-02(w)

S-X Rule 1-02(w) includes three tests used to measure the significance of entities, other than the registrant, for several SEC reporting requirements. The Final Rule amends the existing investment test and the income test and makes other conforming changes.

¹ The Final Rule conforms the definition of “significant subsidiary” in Rule 405 of the Securities Act of 1933 and in Rule 12b-2 of the Securities Exchange Act of 1934 to the amended definition in S-X Rule 1-02(w).

Investment test

Aggregate worldwide market value

The Final Rule amends the investment test used for business acquisitions and dispositions to compare the registrant's and its other subsidiaries' investments in and advances to the tested subsidiary to the aggregate worldwide market value of the registrant's voting and non-voting common equity (referred to as "aggregate worldwide market value"). The amendments are intended to more closely align the denominator in the investment test with the numerator, which is ordinarily the purchase or sale price consistent with the fair value of the net assets of the acquired or disposed business. If a registrant does not have an aggregate worldwide market value, the Final Rule requires it to use the existing investment test and amends the significance test for dispositions to use the carrying value of the disposed subsidiary as the numerator.

The aggregate worldwide market value is calculated as the average of the daily aggregate worldwide market value for the last five trading days of the most recently completed month ending prior to the earlier of either the registrant's announcement date or agreement date of the acquisition or disposition.

Computing significance for other than business acquisitions and dispositions

The amendments to the investment test are limited to that used in computing significance for business acquisitions and dispositions, including real estate operations. The Final Rule retains the existing investment test for all other purposes, such as determining the significance of equity method investees under S-X Rules 3-09 or 4-08(g).

Contingent consideration

Under the amended rules, calculating the investments in a tested subsidiary includes the fair value of contingent consideration required to be recognized by U.S. GAAP or IFRS Standards, as applicable. If contingent consideration is not required to be recognized at fair value at the time of the acquisition, the amendments require a registrant to include all contingent consideration in the numerator, except contingent consideration for which the likelihood of payment is remote.

Income test

Revenue component

The Final Rule amends the income test to add a new revenue component. The revenue component compares the registrant's and its other subsidiaries' proportionate share of the tested subsidiary's consolidated total revenues from continuing operations after eliminating intercompany transactions, to the registrant's consolidated total revenue for the most recently completed fiscal year. Under the amended rule, the tested subsidiary must meet the requisite significance threshold for both the new revenue component and the net income component in order to be considered significant. For the purposes of S-X Rule 3-05, the number of years required for pre-acquisition financial statements is based on the lower of the new revenue component and the net income component. Further, the revenue component applies only when both the registrant and the tested subsidiary have material revenues in each of the two most recently completed fiscal years.

Applicability to equity method investments

Unlike the investment test, amendments to the income test do apply to situations other than business acquisitions and dispositions. Accordingly, the amended income test will be used to determine the significance of equity method investees under S-X Rules 3-09 and 4-08(g).

Income averaging

The Final Rule amends the provisions related to income averaging to require a registrant to use the absolute value of income or loss for each of the preceding five fiscal years in computing average income. However, average income may be used to determine significance only if the revenue component does not apply.

C. Business acquisitions under S-X Rule 3-05

Periods to be presented

The Final Rule amends S-X Rule 3-05 to reduce the maximum number of periods for which audited financial statements must be presented from three years to two years. The revisions also eliminate the requirement for presenting prior-period comparative unaudited interim financial statements when significance does not exceed 40 percent.

Abbreviated financial statements

The Final Rule permits registrants to provide abbreviated financial statements for acquired or to be acquired businesses without first seeking relief from the Commission if all of the following qualifying conditions are met:

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

S-X Rule 3-05, as amended, also includes certain presentation conditions that are largely consistent with existing interpretive guidance. Under the amendments, the abbreviated financial statements must be comprised of the following:

- Statement of assets acquired and liabilities assumed
- Statement of comprehensive income, which must include all expenses incurred by or on behalf of the acquired business, but may omit corporate overhead, interest on debt that is not being assumed, and income tax expense

- Certain accompanying notes to the financial statements

Registration and proxy statements

Acquired business reflected in audited post-acquisition results

S-X Rule 3-05, as amended, will no longer require registrants to include the financial statements of the acquired business in certain registration statements and proxy statements once such business is reflected in the registrant's audited post-acquisition financial statements for at least nine months (when significance exceeds 20 percent but not 40 percent) or for a complete fiscal year (when significance exceeds 40 percent).

Individually insignificant acquisitions

The Final Rule also amends S-X Rule 3-05 to include the definition of individually insignificant acquisitions, which is consistent with existing interpretive guidance.² If the aggregate significance of individually insignificant acquisitions exceeds 50 percent, the amendments require the registrant to file the following information:

- The financial statements of any individually significant acquired or to be acquired business for the most recent fiscal year and the subsequent interim period for which the financial statements are not yet required to be filed
- Pro forma financial information depicting the aggregate effect of all individually insignificant acquisitions, in all material respects

Accelerated timing for providing financial information

If the aggregate significance of individually insignificant acquisitions exceeds 50 percent, the Final Rule requires a registrant to provide financial statements of individually significant consummated and probable acquisitions on an accelerated timeline in certain registration statements and proxy statements. Further, the registrant will require necessary information to prepare pro forma statements to depict the aggregate effect of all businesses in all material respects. The registrant should therefore consider these requirements during the acquisition negotiation process.

Financial statements of a foreign business

The Final Rule amends S-X Rule 3-05 to allow foreign private issuers (FPIs) that prepare their financial statements using IFRS Standards to reconcile the financial statements of an acquired or to be acquired "foreign business" that uses home country GAAP to IFRS Standards rather than to U.S. GAAP.

² See Section 2035.2 in the *Financial Reporting Manual* (FRM) issued by the SEC's Division of Corporation Finance.

S-X Rule 3-05, as amended, also allows the financial statements of an acquired or to be acquired business that is not a foreign business, but would qualify as an FPI if it were a registrant, to be prepared using either

- IFRS Standards without reconciliation to U.S. GAAP, or
- Home country GAAP with a reconciliation to IFRS Standards, if the registrant is an FPI that prepares its financial statements in accordance with IFRS Standards

D. Real estate operations under S-X Rule 3-14

The Final Rule aligns the requirements in S-X Rule 3-14 with those in S-X Rule 3-05 if no unique industry considerations exist that warrant different treatment for real estate operations. The amendments are intended to reduce the complexity of implementing this guidance while retaining industry-specific disclosures, and include the following:

- *Investment test*: Requiring the use of the investment test in amended S-X Rule 1-02(w) for real estate operations, which compares the registrant's and its other subsidiaries' investments in and advances to the acquired or to be acquired real estate operation to the registrant's aggregate worldwide market value. If a registrant does not have a worldwide aggregate market value, the registrant's and its other subsidiaries' investments in the real estate operation, including any debt secured by the property that is assumed by the registrant, is compared to the registrant's total assets.
- *Aligning significance thresholds with those in S-X Rule 3-05*: Increasing the significance threshold to 20 percent for individual acquisitions and 50 percent for aggregated impact of acquisitions that applies to certain registration statements and proxy statements.
- *Acquisitions from a related party*: Eliminating the requirement to provide three years of historical financial statements for acquisitions from related parties.
- *Application of S-X Rule 3-06*: Allowing audited financial statements that cover a nine- to twelve-month period to satisfy the financial statement requirement for one year.
- *Timing for filing in connection with certain registration and proxy statements*: Extending the due date for financial statements to no more than 74 days after consummation of the acquisition.
- *Real estate operations included in post-acquisition results*: No longer requiring historical financial statements in certain registration statements and proxy statements once the acquired real estate operation is included in the registrant's audited post-acquisition financial statements for at least nine months.
- *Interim financial statements*: Expressly requiring historical financial statements for the most recent year-to-date interim period.
- *Triple net leases*: Eliminating alternative disclosure requirements for properties subject to triple net lease.

- *Blind pool offerings*: Codifying existing interpretive guidance³ related to determining significance and extending the adapted significance test to S-X Rule 3-05 acquisitions.

E. Pro forma financial information under S-X Article 11

Adjustment criteria and presentation requirements

The Final Rule replaces the existing pro forma adjustment criteria in S-X Article 11 with three categories of adjustments: (a) Transaction Accounting Adjustments, (b) Autonomous Entity Adjustments, and (c) Management's Adjustments.

Transaction Accounting Adjustments

These adjustments reflect the application of required accounting for the acquisition, disposition, or other transaction on the registrant's financial statements. The registrant is required to depict

- The accounting for the transaction required by U.S. GAAP or IFRS Standards, as applicable, in the pro forma condensed balance sheet.
- The effects of the pro forma balance-sheet adjustments noted above in the pro forma condensed statement of comprehensive income, assuming those adjustments were made as of the beginning of the fiscal year presented. If the adjustment has no balance-sheet effect, then the registrant must reflect the accounting required by U.S. GAAP or IFRS Standards, as applicable, in the pro forma income statement.

Amended S-X Rule 11-02 requires additional disclosures in the explanatory notes, including (1) the total consideration transferred or received, including its components and how they were measured, and (2) a prominent statement to the effect that the initial accounting is incomplete, if applicable, along with certain other related disclosures.

Autonomous Entity Adjustments

These adjustments are required to reflect the financial position and results of operations of the registrant as an autonomous entity if the registrant was previously part of another entity.

Management's Adjustments

These optional adjustments depict synergies and dis-synergies of the acquisitions and dispositions for which pro forma effect is being given. These adjustments may be presented at the discretion of the registrant, if it believes that such adjustments would enhance an understanding of the pro forma effects of the transaction, subject to certain conditions.

Further, the registrant is required to provide additional disclosures in the explanatory notes, including material assumptions or uncertainties, the method of calculating the adjustments, and the estimated time frame for achieving the synergies and dis-synergies.

³ See FRM Section 2325.5.

Form of presentation

The amendments require registrants to present historical and pro forma income from continuing operations attributable to controlling interests and earnings per share (EPS) data on the face of the pro forma condensed statement of comprehensive income, giving effect to Transaction Accounting Adjustments and Autonomous Entity Adjustments. The amendments also require the disclosure of revenues, expenses, gains and losses, and related tax effects that will not recur in the registrant's income beyond 12 months after the transaction.

Presenting pro forma adjustments

Transaction Accounting Adjustments and Autonomous Entity Adjustments are required to be presented in separate columns in the pro forma financial information.

Management's Adjustments, when presented, must be included in the explanatory notes as a reconciliation of pro forma net income from continuing operations attributable to controlling interest and the related pro forma EPS data after giving effect to Transaction Accounting and Autonomous Entity Adjustments.

Dispositions

The Final Rule revises S-X Rule 11-01(b) to raise the significance threshold from 10 percent to 20 percent for the disposition of a business, including real estate operations.

Use of pro forma financial information in measuring significance

The Final Rule expands the circumstances in which pro forma information may be used for determining the significance of an acquisition or a disposition. For filings that require financial statements under S-X Rule 3-05 or Rule 3-14, the amendments allow registrants to measure significance using filed pro forma financial information that only includes significant business acquisitions and dispositions consummated subsequent to the most recently completed fiscal year for which financial statements are required to be filed, provided that the registrant has filed the following:

- Financial statements under S-X Rules 3-05 or 3-14 for any such acquired business
- Pro forma financial information required by S-X Article 11 for any such acquired or disposed business

The Final Rule further clarifies that the pro forma financial information used to determine significance must be limited to the applicable amounts that combine the historical financial information of the registrant and the acquired business and gives effect to Transaction Accounting Adjustments.

F. Investment companies

Ordinarily, investment companies, including BDCs, apply the provisions of Articles 1 through 4 under Regulation S-X, unless they are instead subject to the specific provisions of Article 6, *Registered investment companies and business development companies*. In response to considerations particular to investment companies, the Final Rule adds a new definition of "significant subsidiary" for investment companies and provides tailored disclosure requirements regarding fund acquisitions.

The new definition includes subsidiaries that meet either of the investment or income significance tests specified within the new S-X Rule 6-11, and Section 2(a)(41) of the Investment Company Act of 1940, if applicable. Under the new rule, the asset test is no longer applicable to investment companies.

S-X Rule 6-11 uses the new significance test found in S-X Rule 1-02(w)(2), with specified modifications to the thresholds. S-X Rule 6-11 specifies the financial statement and schedule requirements, including the periods to be presented for acquired funds. In addition, this new rule eliminates the requirement to provide pro forma financial information for fund acquisitions and instead specifies the supplemental financial information required, as described under S-X Rule 6-11(d). Finally, the Final Rule amends Form N-14 to make the disclosure requirements consistent with S-X Rule 6-11.

G. Transition guidance

The Final Rule is effective for fiscal years beginning after December 31, 2020 (mandatory compliance date). All acquisitions and dispositions that are probable or consummated after the mandatory compliance date are required to be evaluated for significance using the amended rule.

For initial registration statements filed on or after the mandatory compliance date, registrants are required to assess all probable and consummated acquisitions and dispositions using the amended significance tests, regardless of whether the transaction occurred prior to the mandatory compliance date.

If a registrant that is subject to reporting obligations under the Securities Exchange Act of 1934 files a registration statement on or after the mandatory compliance date, the registrant is permitted to compute the significance of an acquisition or disposition using the rules that were in effect at the time of consummation of the transaction.

Voluntary compliance with the amendments is permitted prior to the mandatory compliance date. If a registrant voluntarily complies, it is required to apply the amendments in their entirety from the date of early compliance.

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