The proposal aims to improve the financial information registrants provide about businesses they acquire or dispose, facilitate more timely access to capital, and reduce the complexity and costs of preparing the information.

**What you need to know**

- The SEC proposed changes to the significance tests registrants perform to determine whether to provide financial statements of businesses they acquire and pro forma information for those transactions. Registrants would consider their market capitalization in the investment test and both their revenue and after-tax income in the income test.

- The proposal would formalize existing practice around providing abbreviated financial statements of acquired businesses in certain circumstances.

- The proposal would eliminate any requirement to provide three years of financial statements for an acquired business or a probable acquisition.

- The pro forma financial information requirements would focus not only on the purchase accounting performed under US GAAP or IFRS but also management’s expectations for synergies and other plans that are reasonably estimable and reasonably expected to occur.

- The significance threshold for reporting a registrant’s disposal of a business and related pro forma information would increase to 20% from 10%.

- Comments are due within 60 days of publication in the Federal Register.

**Overview**

The Securities and Exchange Commission (SEC) proposed amendments to its rules that require registrants to file separate audited financial statements and pro forma financial information when they acquire a business that is considered significant under one of three tests.
The proposal is intended to reduce the burden of preparing the disclosures, reduce the chances of immaterial acquisitions being deemed significant and provide investors with more meaningful disclosures. It is part of the SEC’s disclosure effectiveness initiative.

“The proposed rules are, first and foremost, intended to ensure that investors receive the financial information necessary to understand the potential effects of significant acquisitions or dispositions,” SEC Chairman Jay Clayton said. “[The staff’s] work to eliminate unnecessary costs and burdens of the current rules – which in some cases have been significant and frustrated otherwise attractive transactions – while at the same time improving the disclosures investors receive should be applauded.”

The proposal would affect reporting for a broad range of transactions although its changes to the financial statement requirements would not apply to the acquisition of a business that is the subject of a proxy statement or registration statement on Forms S-4 or F-4.

**Key considerations**

**Revisions to the significance tests**

The SEC proposed revising the significance tests in Rule 1-02(w) of Regulation S-X that are used to determine whether a registrant needs to provide financial statements of a business it acquires and, if so, how many periods must be presented. The SEC expects the revisions to help registrants make more meaningful significance determinations and reduce the need to seek relief under Rule 3-13 of Regulation S-X.

The investment test would be revised to compare, in most cases, the fair value of the purchase consideration determined in accordance with US GAAP or IFRS to the aggregate worldwide market value of the registrant’s voting and nonvoting common equity. The investment test currently compares the fair value of the purchase consideration to the total assets of a registrant as reported on its latest audited balance sheet. The proposal would retain the asset test, which compares the assets of the acquired business to those of the registrant as reported on its latest audited balance sheet.

The SEC also proposed revising the income test to require registrants to compare both their revenue and income to that of an acquired business. The revised test would use after-tax income from continuing operations rather than pretax income from continuing operations. The result of the new income test would be the lower significance from the revenue and after-tax income calculations.

The proposal also would revise the significance tests and raise the threshold for Form 8-K reporting of disposals of businesses to 20% from 10% to align with the requirements for acquisitions. The SEC said it did not observe any characteristics of disposals that warranted different treatment.

The SEC also proposed replacing the requirement that registration statements include financial statements and pro forma financial information for the “mathematical majority” of the acquisitions that are significant in the aggregate with a requirement that they include only the financial statements of those acquisitions that individually exceed 20% significance, along with pro forma financial information about the aggregate effect of all the acquisitions, in all material respects.
How we see it
Using a registrant’s market capitalization in the investment test and adding a revenue component to the income test would reduce the number of anomalous significance test results (e.g., when a registrant is operating at or near a breakeven) and, therefore, reduce the need to seek relief from the SEC staff. However, introducing income taxes could affect the results, and registrants may still end up seeking relief if different tax structures or sizable one-time tax items cause anomalous results under the revised test.

Expanded use of abbreviated financial statements
The SEC proposed new S-X Rule 3-05(e) to address acquisitions of partial components of entities (e.g., an acquired product line, a component of a legal entity).

The proposal would permit registrants to provide audited financial statements of assets acquired and liabilities assumed, and statements of revenues and expenses (exclusive of corporate overhead, interest and income tax expense), which the SEC refers to as abbreviated financial statements, if all three of these conditions are met:

- The business constitutes less than substantially all of the assets and liabilities of the seller and was not a separate entity, subsidiary, segment or division during the periods for which the acquired business financial statements would be provided.
- Separate financial statements for the business have not previously been prepared.
- The seller has not maintained the separate accounts necessary to present financial statements that include the omitted expenses, and it is impracticable to prepare such financial statements.

A registrant would not be able to exclude from abbreviated financial statements various items such as interest expense for debt assumed from the seller or various operating expenses paid by or on behalf of the business. The notes to the abbreviated financial statements would have to include disclosure about the type of omitted expenses, the reasons why they were excluded and how the statements are not indicative of the acquired business going forward, as well as available information about the operating, investing and financing cash flows of the business.

The proposal also would create similar requirements in new S-X Rule 3-05(f) for businesses engaged in oil and gas producing activities.

How we see it
While this proposal is consistent with current practice, registrants would no longer have to seek relief from the SEC staff to provide abbreviated financial statements or rely on informal staff guidance that allows relief in certain situations. We believe that the proposal would result in more consistent financial reporting for similar transactions because it would set specific criteria for providing abbreviated financial statements and requirements for their content.

Reduce the number of audited and interim periods
The SEC proposed eliminating today’s requirement that registrants provide three years of financial statements for acquisitions that individually exceed 50% significance. Registrants would still be required to provide one year of financial statements for acquired businesses that individually exceed 20% significance and two years of financial statements for those that individually exceed 40%. The SEC also proposed eliminating today’s requirement that registrants provide unaudited interim financial statements for the prior-year comparative period when only one year of audited financial statements is required.
In addition, the SEC proposed eliminating any requirement that registration statements include pre-acquisition financial statements of any acquired business that has already been included in post-acquisition results for a complete fiscal year.

**How we see it**
Companies conducting initial public offerings (IPOs) would be allowed to omit pre-acquisition financial statements of significant acquired businesses that they have included in their consolidated financial statements for at least a year, which would provide significant relief for IPO candidates compared to the current requirements.

**Improve the relevance of pro forma financial information**
The SEC proposed significant modifications to the form and content of pro forma financial information. The proposal would eliminate today’s restrictive criteria for pro forma adjustments and replace them with two categories of adjustments: (1) transaction accounting adjustments that would reflect the estimated purchase accounting under US GAAP or IFRS and (2) management adjustments that would include reasonably estimable synergies and other transaction effects that have occurred or are reasonably expected to occur.

The management adjustments would be shown in a separate column after the presentation of the combined historical information of the registrant and the acquired business and the transaction accounting adjustments.

**How we see it**
Replacing today’s restrictive criteria for pro forma adjustments with more flexible criteria would allow registrants to present pro forma financial information that is more indicative of the financial effect of the acquisition on the combined entity.

However, registrants may have to exercise more judgment in determining the management adjustments, and this could increase preparation time.

**Other changes**
The proposal would align key provisions of Rule 3-14 regarding significant real estate operations with the proposed changes to Rule 3-05. For example, the proposal would increase the significance threshold to 20% from 10% and eliminate the requirement to provide three years of financial statements for a real estate operation acquired from a related party.

The proposal also would expand the ability of a registrant to provide financial statements of an acquired business using IFRS without a reconciliation to US GAAP if the business would qualify as a foreign private issuer on its own. Currently, the acquired business must qualify as a “foreign business,” which is more restrictive.

The requirements related to financial statements of a business acquisition for smaller reporting companies and Regulation A issuers would be conformed, but the form and content of the financial statements for both would continue to be dictated by Article 8 of Regulation S-X.

The SEC also proposed new S-X Rule 6-11 and amendments to Form N-14 to address the unique characteristics of acquisitions involving investment companies and business development companies.