Katten

SECURITIES ADVISORY

# Public Company Acquired Company Financial Statement Rules

September 16, 2020

**KEY POINTS**

- In May, the Securities and Exchange Commission (SEC) adopted amended rules relating to acquired company financial statements. This advisory discusses the amended requirements and updated tests for determining what constitutes a significant subsidiary.
- This advisory also addresses new rules relating to preparation of pro forma financial statements.

## Acquired Company Financials — Generally

Under the rules of the Securities and Exchange Commission (SEC), registrants are generally required to file audited annual and unaudited interim pre-acquisition financial statements of businesses that they acquire, if the acquired company would be a "significant subsidiary" of the registrant as defined in Rule 1-02(w) of Regulation S-X. Further, pursuant to Article 11 of Regulation S-X, registrants are required to provide pro forma financial information in the case of an acquisition or disposition of a significant subsidiary, presenting unaudited pro forma financial information adjusted to give effect to the acquisition or disposition.

In May, the SEC adopted amended rules designed to streamline certain requirements related to providing acquired company financial statements and the tests for determining what constitutes a significant subsidiary (the 2020 Amendments). The 2020 Amendments updated the significance tests used to determine when transactions trigger a requirement to provide financial statements, reduced the historical periods required to be presented in acquired company financial statements and amended the requirements applicable to the presentation of pro forma financial information in connection with significant transactions. The new rules are effective as of January 1, 2021 and apply with respect to a registrant's fiscal year beginning after December 31, although voluntary compliance is permitted prior to the effective date, so long as the new rules are applied in their entirety.

This discussion gives effect to the implementation of the 2020 Amendments.

## Relevant Transactions

***Acquisition of a "business"***

Under Rule 3-05 of Regulation S-X, acquired company financial statements are required to be filed by a registrant when an acquisition of a significant "business" has occurred or, under circumstances discussed herein with respect to registration statements or proxy statements, is "probable." The SEC has indicated that whether a transaction is "probable" requires a consideration of all available facts. In this regard, financial statements for a target company should be provided for a potential transaction, where the registrant's financial statements alone "would not provide adequate financial information to make an investment decision." See SEC Financial Reporting Manual, Topic 2005.4.

Rule 11-01(d) of Regulation S-X provides that the term "business" should be "evaluated in light of the facts and circumstances involved" and "whether there is sufficient continuity" of the entity's operations prior to and after the transactions such that disclosure of the financial information is material to an understanding of future operations. There is a presumption that a separate entity, subsidiary or a division is a "business." For lesser components, such as a product line, Rule 11-01(d) of Regulation S-X requires registrants to consider:

1. whether the nature of the revenue-producing activity of the component will remain generally the same; or
2. whether the facilities, employee base, distribution system, sales force, customer base, operating rights, production techniques or trade names remain after the acquisition.

Given the case-by-case analysis that must be done, the SEC has historically encouraged registrants succeeding to a revenue producing activity by merger or acquisition to obtain concurrence from the staff of the Division of Corporation Finance, if they intend to omit financial statements related to an acquisition.

***Multiple transactions***

Acquisitions of multiple "related businesses" must be aggregated and treated as a single business for purposes of the significance tests, if the businesses are under common control or management, or the acquisitions are dependent on each other or a single common event or condition.

Similarly, under certain circumstances, individually insignificant acquisitions must be aggregated and acquired company financial presented in a registration statement or proxy statement if, in the aggregate, such acquisitions exceed 50 percent in significance. Individually insignificant businesses include (1) any acquisition consummated after the audited balance sheet date of the registrant that does not exceed 20 percent in significance, (2) any probable acquisition that does not exceed 50 percent and (3) any other consummated acquisition that exceeds 20 percent but not 50 percent in significance and for which the acquired company financial statements are not yet required to be filed. In the case of individually insignificant acquisitions, the registrant must provide historical financial statements in the registration statement or proxy statement, as applicable, only for the businesses whose individual significance exceeds 20 percent but provide pro forma financial information depicting the effects of all of the individually insignificant businesses.

## Measuring Significance

Once a registrant has determined that it is acquiring or disposing of a business, it must determine the level of significance of the transaction in order to identify what financial statements, if any, are required in connection with the transaction. The relevant significance tests, updated for the 2020 Amendments, as set forth in Rule 1-02(w) of Regulation S-X, are as follows:

<table>
<tr><td rowspan="2">Net Income and Revenue Test</td><td>(a) Target’s income from continuing operations before income taxes/registrant’s income from continuing operations before income taxes;<br>and<br>(b) Target’s consolidated total revenues from continuing operations (after intercompany eliminations)/registrant’s consolidated total revenues.</td></tr>
<tr><td>1. Significance is only met if <u>both</u> the revenue and net income components exceed the applicable threshold and the <u>lowest</u> significance of the two components is used to determine the number of periods for which financial statements are required.<br>2. If either company does not have material revenues in each of the two most recently completed fiscal years, then only the net income component of the test applies.<br>3. The net income component is calculated using absolute values in lieu of negative amounts.<br>4. When the revenue component does not apply and the net income test is at least 10 percent lower than the average of the absolute value of such amounts for the last five fiscal years, the average net income for such period is used instead, with loss years assigned a value of zero.</td></tr>
<tr><td rowspan="2">Investment Test</td><td>(a) Registrant’s investments in and advances to the target/the aggregate worldwide market value of the registrant’s voting and non-voting common equity, when available;<br>or, if the acquirer does not have a worldwide market value that can be calculated,<br>(b) Registrant’s investments in and advances to the target/registrant’s total assets.</td></tr>
<tr><td>1. Aggregate worldwide market value is calculated by averaging the aggregate <u>worldwide market value</u> calculated daily for the last five trading days of the most recent month ending prior to the earlier of the registrant’s announcement date or agreement date of the acquisition.<br>2. The worldwide market value test may only be used for determining required financial statements for acquisitions and dispositions and only the asset test may be used for the additional purposes for which the Rule 1-02(w) definition of “significant subsidiary” is applicable.<br>3. Investment amount is generally the purchase price or consideration paid for the target. Investment amount must include the fair value of contingent consideration, if required to be recognized at the acquisition date under applicable accounting rules, or if not required to be recognized at fair value, all contingent consideration except where the likelihood of payment is remote.<br>4. The investment test is deemed met when the net book value of the target exceeds 10 percent of the registrant’s total assets or, in a combination between entities under common control, where the consideration includes stock consideration, the number of shares exchanged exceeds 10 percent of the registrant’s total common shares outstanding as of the date of the combination.<br>5. In the case of a disposition, the registrant’s investment in the subsidiary is the fair value of the consideration (including contingent consideration) paid for the subsidiary, in the case when compared to aggregate worldwide market value, or the carrying value of the disposed subsidiary, when compared to the registrant’s total assets.<br>6. When the registrant does not have a worldwide market value that can be calculated, only the legacy investment test is to be used.</td></tr>
</table>

| Total Assets Test | • Target's total assets/registrant's total assets |
|---|---|
| | 1. Intercompany transactions with the acquired business must be eliminated from the registrant's and the target's consolidated total assets. |

Prior to the adoption of the 2020 Amendments, no revenue component existed for purposes of the significant subsidiary determination. Historically, application of the net income test alone could lead to anomalous results, particularly given the fact that a registrant's reported pre-tax income may not have been representative of its overall size or indicative of whether the acquisition of a target company was truly meaningful. The addition of the revenue component was designed to address these issues. Similarly, prior to the adoption of the 2020 Amendments, the investment test did not include a worldwide market value component and only compared the registrant's investments in and advances to the target company (typically, the purchase price) to the registrant's total assets. Thus, there was a perceived mismatch in this legacy test, as it compared a fair value metric (investments and advances) to a book value metric (total assets). While this was addressed by the 2020 Amendments, it is possible that situations will arise in which application of the worldwide market value component will yield a higher significance result than would have application of the total assets component of the investment test. Unlike with respect to the net income and revenue test, upon effectiveness of the 2020 Amendments, registrants will not be able to elect the "lowest of" result with respect to either the worldwide market value component or the total assets component of the investment test.[1] The total assets test was substantively unchanged by the 2020 Amendments.

***Financial statements used for calculating significance***

Significance must be calculated using the registrant's most recent annual financial statements required to be filed at or prior to the date of the acquisition and the target's pre-acquisition financial statements for the same fiscal year (or, if the fiscal year is different, the target's most recent fiscal year that would be required if the target had the same filer status as the registrant). However, a registrant may determine significance using amounts reported in its most recent Annual Report on Form 10-K, when the registrant has filed its Form 10-K after the acquisition has been consummated but before the registrant is required to file the acquired company financial statements.

Registrants are permitted, following the 2020 Amendments, to measure significance using pro forma financial information that depicts significant acquisitions and dispositions consummated after the last fiscal year, so long as the registrant has filed the required historical and pro forma financial information for the transactions. Such pro forma financial information may be used to measure significance only to the extent it gives effect to the acquired or disposed of business, and not any other transactions or adjustments, such as adjustments to reflect the operations and financial position of the registrant as an autonomous entity in cases when it was previously part of another entity (referred to below as Autonomous Entity Adjustments), adjustments that include forward-looking information that depict synergies and dis-synergies (referred to below as Management's Adjustments) or the use of proceeds from an offering.

Once a reporting company uses pro forma financial information to measure significance, it must continue to do so until the next annual report.

[1] Under Rule 3-13 of Regulation S-X, registrants may seek relief from the SEC from a requirement to provide required financial statements where such relief is "consistent with the protection of investors." Registrants should be mindful of the relief available under Rule 3-13 where application of the significance tests continue to yield anomalous results.

## Required Financial Statements

Under Rule 3-05 of Regulation S-X, the scope of required acquired company financials is based on the level of significance of the acquisition. The rules provide that acquired company financial statements are required if any of the three significance tests discussed above meet the applicable thresholds as set forth in the following table:

| Significance | Audited Financials | Unaudited Interim Financials | Pro Forma Financials |
|---|---|---|---|
| 20 percent or less | None | None | None |
| Greater than 20  percent to 40 percent | One year | Most recent interim period (no comparative interim period) | Yes |
| Greater than 40 percent | Two years | Any interim period (including comparative interim period) | Yes |

***Periods presented***

As indicated in the table above, either one year or two years of audited financial statements of the target company may be required in connection with an acquisition, depending on significance. The 2020 Amendments eliminated the requirement to provide three years of audited financial statements where significance exceeded 50 percent. With respect to acquisitions greater than 20 percent significance but less than 40 percent significance, the requirement to provide unaudited interim financials was reduced from “any” interim period to just the “most recent” interim period, eliminating the requirement to provide a comparative interim period in cases when only one year of audited financial statements of the target must be presented.

***Dispositions***

In the case of dispositions, following the 2020 Amendments, pro forma financial statements must only be filed with respect to dispositions that are significant in excess of 20 percent (not 10 percent).  Significance of a disposed business should be calculated using the significant subsidiary tests set forth in Rule 1-02(w), discussed above.

***Abbreviated financial statements***

Where a registrant acquires a component of an entity that is a “business” within the meaning of Regulation S-X but does not constitute a separate entity, subsidiary or division, registrants may provide abbreviated financial statements if certain conditions are met. Specifically, the total assets and revenues of the acquired business must constitute 20 percent or less of each of the seller’s total assets and revenues, the acquired business must not have been a separate entity, subsidiary, operating segment or division during the periods for which acquired company financial statements would be required, separate financial statements for the business must not have been previously prepared and the seller must not have maintained distinct and separate accounts necessary to present the financial statements necessary to include the omitted expenses, and it is impracticable to prepare such financial statements. In the case of a qualifying transaction for abbreviated financial statements, the balance sheet may be limited to a statement of assets acquired and liabilities assumed, and the statement of comprehensive income may be limited to a statement or revenues and expenses with certain otherwise required line items excluded, such as certain corporate overhead expenses, income tax expense and interest expense (where the debt to which interest expense relates will not be assumed by the registrant).

*Smaller reporting companies and regulation A offerings*

Acquired company financial statements for smaller reporting companies and issuers relying on Regulation A are set forth in Article 8 of Regulation S-X. As part of the 2020 Amendments, Article 8 was amended such that the separate requirements instead reference the requirements set forth in Rule 3-05 (as discussed above). The rules relating to form and content for such financial statements, including the ability of smaller reporting companies and issuers relying on Regulation A to provide reduced disclosures, remain unchanged. In addition, pursuant to the 2020 Amendments, Article 8 of Regulation S-X was amended to clarify that pro forma financial information required to be presented by smaller reporting companies and issuers relying on Regulation A should be filed in compliance with the preparation, presentation and disclosure requirements of Article 11 (discussed below).

*Foreign private issuers*

Foreign private issuers that prepare their financial statements using IFRS-IASB may reconcile required acquired company financial statements that have been prepared in accordance with a target's home country GAAP to IFRS-IASB, as opposed to U.S. GAAP. Similarly, where a target company would qualify as a foreign private issuer if it were a registrant, the acquired company financials may be presented in accordance with IFRS-IASB without reconciliation to U.S. GAAP.

## Timing for Filing Financial Statements

Generally, a reporting company must file a Current Report on Form 8-K disclosing an acquisition exceeding 20 percent significance within four business days of consummating the acquisition. The required acquired company financial statements, together with pro forma financial statements, if required, for the acquisition must be filed by an amendment to the Form 8-K no later than 71 calendar days after the initial Form 8-K was required to be filed (i.e., 71 calendar days plus four business days after consummation of the acquisition). With respect to any disposition of a significant subsidiary, pro forma financial statements must be filed no later than four business days following the disposition, without regard to the 71 calendar day period applicable to acquisitions.

In the case of a registration statement or proxy statement, required acquired company financial statements for an acquisition less than or equal to 50 percent significance need not be included unless the registration statement is declared effective, or the proxy statement is mailed, 75 days or more after the acquisition is consummated. Where the acquisition or probable acquisition exceeds 50 percent significance, or involves individually insignificant businesses required to be aggregated exceeding 50 percent in significance (as discussed above), the required acquired company financial statements must be included in the registration statement or proxy statement at the time of effectiveness or mailing, as applicable. Following the 2020 Amendments, registrants are no longer required to include acquired company financial statements in registration statements or proxy statements if, (1) in the case of significance greater than 20 percent but less than 40 percent, the target's results are included in the registrant's financial statements for at least nine months or (2) in the case of significance greater than 40 percent, the target's results are included in the registrant's financial statements for a full fiscal year. The requirement to continue providing acquired company financial statements in registration statements and proxy statements for transactions of "major significance" has been eliminated.

## Pro Forma Financial Statement Requirements

Prior to the 2020 Amendments, Article 11 of Regulation S-X required pro forma financial information to show the impact of an acquisition or disposition on a registrant's results by presenting adjustments that were (1) directly attributable to the transaction, (2) expected to have a continuing impact on the company and (3) factually supportable.

The SEC attempted to simplify the pro forma disclosure requirements with the 2020 Amendments with a new revised framework requiring registrants to present:

- adjustments for transaction accounting, reflecting only the application of required accounting to the transactions and linking the effects of the transaction to the registrant's audited historical financial statements (Transaction Accounting Adjustments);
- adjustments to reflect the operations and financial position of the reporting company as an autonomous entity (if previously part of another entity) (Autonomous Entity Adjustments); and
- at the registrant's option, adjustments for synergies and dis-synergies identified by management when consummating a transaction (Management's Adjustments).

To the extent included, Management's Adjustments may present such synergies and dis-synergies that would enhance an understanding of the pro forma effects of the transaction being presented. In order to present Management's Adjustment, certain conditions must be satisfied, including that:

- there is a reasonable basis for each adjustment;
- adjustments be limited to the effect of synergies and dis-synergies on the historical financial statements as if they existed as of the beginning of the fiscal year presented; and
- all Management's Adjustments that are, in management's opinion, necessary to a fair statement of the pro forma financial, be presented and that any synergies presented be accompanied with any related dis-synergies.

In addition, Management's Adjustments, if included, must be presented in the explanatory notes to the pro forma financial information, must be as of the most recent practicable date prior to the effective date, mailing date or filing date of the registration statement, proxy statement or Form 8-K in which they are included, to the extent any adjustment changes the number of shares of common stock, such change must be presented in accordance with U.S. GAAP or IFRS-IASB, as applicable, and must include within the explanatory note the basis for and material limitations of each Management's Adjustment. If included, any such forward-looking information presented within Management's Adjustments is expressly covered by the safe harbor provisions for forward-looking information under Rule 175 under the Securities Act of 1933 and Rule 3b-6 under the Securities Exchange Act of 1934.

## CONTACTS

For more information, or if you have any questions regarding any of the topics discussed in this advisory, please contact the authors of this advisory directly: Mark Wood and Brian Hecht; the other members of the Katten Securities group listed below; or your primary Katten attorney.

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