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SEC proposes changes to disclosures about acquired and disposed businesses

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

Applicability

Public companies, including foreign private issuers, registered investment companies and registered investment advisers.

Key changes

The proposed rule would amend requirements for providing financial statements and other financial information relating to acquisitions and dispositions of businesses, including real estate operations.[2] The SEC believes that the amendments would improve the financial information provided to investors about acquired and disposed businesses, facilitate more timely access to capital, and reduce the complexity and costs to prepare these disclosures.

The SEC is also proposing a new rule to specifically govern financial reporting for acquisitions involving investment companies.

The key changes relate to:

- the tests to determine the significance of acquisitions and required information;
- Rule 3-05 financial statements included in registration statements and proxy statements;
- pro forma financial information;
- financial disclosure about acquisitions specific to investment companies; and
- foreign business requirements.

Comments are due July 29, 2019.

Background

When a company acquires a business or a real estate operation (a business), it is generally required to provide annual and interim financial statements of the business, if significant. To determine the significance[3] of a business, the company applies the investment, asset and income tests using certain thresholds.

1 SEC Release Nos. 33-10635; 34-85765, Amendments to Financial Disclosures about Acquired and Disposed Businesses

2 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, of Regulation S-X

3 Significant subsidiary as defined in Rule 1-02(w).

Pro forma financial information is prepared for significant acquisitions and dispositions. Typically, pro forma financial information includes the most recent balance sheet and most recent 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.

The proposed rules aim to improve and simplify the required significance tests by aligning and clarifying components of the rules and codifying current permissible practices.

Investment companies often struggle with applying the current guidance due to their unique industry circumstances. To address some of the challenges, the SEC has proposed adding a definition of significant subsidiary that is specifically tailored for investment companies by focusing on financial information that is reported by and most relevant to investment companies.

The proposal would also create a new rule which would apply to the acquisition of another investment company, including a business development company, a private fund and any private account managed by an investment adviser. Under the proposed rule, investment companies may provide US GAAP financial statements of the acquired private fund, but must include a schedule of investments and other supplemental information. Additionally, only one year of audited financial statements of acquired funds would be required.

Significance tests and required information

Current rule	SEC's proposal
Significance thresholds and required periods	
Rule 3-05	
The number of periods financial statements are required for a significant acquired business is determined using a sliding scale: — None – less than or equal to 20%; — One year – exceeds 20%, and up to 40%; — Two years – exceeds 40%, and up to 50%; and — Three years – exceeds 50%, unless certain exceptions apply.	Would eliminate the requirement to file a third year of financial statements by eliminating the exceeds 50% threshold for individual acquisitions.
Dispositions are significant at the 10% threshold.	Would conform the significance tests and thresholds for dispositions to those of acquisitions.
Interim statements may be required based on timing.	Interim statements would only be required for the most recent interim period where a significance test exceeds 20%, but none exceeds 40%. Over 40% requires the comparative period's interim statements.
For aggregated, individually insignificant acquired businesses exceeding 50%, provide audited historical pre-acquisition financial statements covering at least the substantial majority of acquired businesses.	Would provide pro forma financial information illustrating the effects of all aggregated individually insignificant acquired businesses and financial statements for only those businesses that individually exceed 20%.
In certain circumstances, permits testing the significance of acquisitions using pro forma financial information of the company included in a Form 8-K filing as the denominator.	Would expand the use of filed pro forma financial information as the denominator for significance testing to allow pro formas for all filings, including IPOs, that require acquired or disposed business financial statements.

Current rule	SEC's proposal
Significance thresholds and required periods	
— Not available for significant dispositions or initial registration statements (IPOs). — The SEC staff will not object to the use of SAB 80[4], which permits the use of pro forma, financial information to measure significance in an initial registration statement, if certain conditions are met.	
Relief is generally granted by the SEC to provide abbreviated financial statements for an acquired component of an entity that meets the definition of the business.	Would codify current practice by permitting companies to provide abbreviated financial statements if certain conditions are met.
Rule 3-14	
Acquisitions and dispositions are considered significant when any test exceeds the 10% threshold.	Would increase the significance threshold to 20%.
For aggregated businesses that exceed 10%, financial statements of businesses that exceed 5%.	Would align the significance threshold for aggregated businesses to the exceeds 20% level.
In general, one year of financial statements for unrelated properties, otherwise three years.	Would conform to the proposed Rule 3-05 thresholds.
Investment test	
Rule 3-05	
Ratio of the company's investment in, and advances to, the acquired business to the company's total assets as of the end of the most recently completed fiscal year.	Would use the company's aggregate worldwide market value[5] on the last day of its most recent fiscal year-end, when available[6], as the denominator to calculate the ratio of the company's investment in, and cash advances to, the acquired business.
Rule 3-14	
Same significance test as discussed above; however, in practice, the numerator is modified to include any debt secured by the real properties assumed by the company in its investment in the business.	Would codify the current practice of using a modified version of the investment test.

4 Staff Accounting Bulletin No. 80, Application of Rule 3-05 in Initial Public Offerings

5 The proposed Rule looks to the value of common equity held by affiliates, rather than Rule 12b-2, which looks to the value of common equity held by non-affiliates, and is determined as of the last business day of the company's most recently completed second fiscal quarter.

6 If the company does not have an aggregate worldwide market value, the SEC proposal would retain the existing test.

Current rule	SEC's proposal
Income test – Rule 3-05	
Ratio of the company's equity in the income from continuing operations of the acquired business before income taxes, excluding amounts attributable to any noncontrolling interests, to the same measure of the company.	Would use the lower of the company's proportionate share of the acquired business's total consolidated revenues compared to the company's income or loss from continuing operations after income taxes (income test) and total consolidated revenues (revenue test).[7]
Income averaging	
Permits substitution of average income if income for the most recent fiscal year is at least 10% lower than the average of the income for the last five fiscal years.	— Would require using the average of the absolute value of net income when the existing 10% threshold is met and the proposed revenue component does not apply. — The company would use the lower of the revenue and net income tests to determine the number of periods.
Asset test – Rule 3-05	
Ratio of proportionate share of the acquired business's total assets to the total assets of the company, using the most recent annual financial statements.	Would retain the existing asset test.

KPMG observation

At times, the income test can produce anomalous results. Typically this occurs when the company has near break-even results or when either entity has large, nonrecurring income or expenses in the period tested. Considering both revenues and net income in determining significance is intended to avoid those anomalies and result in fewer instances where significance thresholds are exceeded.

The SEC staff frequently considers waivers in these circumstances, and the modifications are intended to save cost and time for companies and the SEC. The change to the income test, however, may result in increases to that threshold, such as when a company has a significant tax expense.

Rule 3-05 financial statements included in registration and proxy statements[8]

Current rule	SEC's proposal
— Financial statements can generally be omitted once the operating results of the acquired business have been reflected in the audited consolidated financial statements of the company for a complete fiscal year, unless they have not previously been provided or are of major significance. Practice provides for certain exceptions.	Would remove the current requirement to include financial statements once the acquired business is reflected in filed post-acquisition financial statements for a complete fiscal year. This would eliminate the requirement to provide financial statements when: — they have not been previously filed; or — they have been filed, but the acquired business is of major significance to the company.

7 The revenue test would not apply to companies or acquirees that do not have revenue.

8 The proposal would also align Rule 3-14 to these proposed amendments.

Current rule	SEC's proposal
— However, acquired business financial statements are required to be included when: – they have not been previously filed; or – financial statements have been filed, but the acquired business is of major significance[9] to the company.	

KPMG observation
This change would affect companies preparing for IPOs that have conducted acquisitions during financial reporting periods required to be included in the registration statement. Currently, these companies must request relief from the SEC staff if information is not readily available and if they no longer have the resources to prepare this information. These requirements may have made mergers and acquisitions less attractive, and ultimately created barriers to capital formation. The proposed amendments are intended to mitigate these burdens.

Pro forma financial information

Current rule	SEC's proposal
Allows adjustments to the pro forma condensed statement of comprehensive income that are: — directly attributable to the transaction; — expected to have a continuing effect on the company; and — factually supportable.	Would allow: — the accounting for the transaction illustrating the effects of the acquired business to the company's audited historical financial statements (Transaction Accounting Adjustments); and — forward-looking information that depicts the reasonably estimable synergies and other transaction effects that have occurred, or are reasonably expected to occur (Management's Adjustments).
Allows adjustments to the pro forma balance sheet that, regardless of whether the effect is expected to be continuing or nonrecurring, are: — directly attributable to the transaction; and — factually supportable.	

KPMG observation
The SEC is proposing to permit more forward-looking adjustments in pro forma financial information for the benefit of investors. Adjustments to the pro forma financial information for synergies and other effects of the transaction are intended to provide insight about management's expectations of how the transaction will affect its business. Determining Management's Adjustments will require making estimates and assumptions. These adjustments introduce further judgment into the pro forma financial statements, potentially making them less consistent across companies.

9 Under current Rule 3-05(b)(4)(iii), companies must also continue to present acquired business's financial statements that have been previously filed if the acquired business is of such significance (i.e. 80%) to the company that omission of those financial statements would materially impair an investor's ability to understand the historical financial results of the company.

Financial disclosure about acquisitions specific to investment companies

Current rule	SEC's proposal
Significant thresholds and required periods	
Follows Rule 3-05 as discussed above.	A subsidiary would be deemed significant if the income test exceeds either (1) 80% by itself, or (2) 10% and the investment test yields a result of greater than 5% (alternate income test).
Investment test	
Follows Rule 3-05 as discussed above.	Would use the ratio of the value of the company's investment in, and advances to, the acquiree to the value of the total consolidated investments of the company as of the end of the most recently completed fiscal year.
Income test	
Follows Rule 3-05 as discussed above.	Would use the ratio of the absolute value of dividends, interest, other income, any net realized gains and losses on investments, and the net change in unrealized gains and losses to the company's consolidated change in net assets resulting from operations.
Asset test	
Follows Rule 3-05 as discussed above.	Would eliminate the asset test.

KPMG observation

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

Foreign businesses

Current rule	SEC's proposal
Requires financial statements of an acquired business that does not meet the definition of a foreign business to be prepared using US GAAP.	Would permit the financial statements of an acquired business to be prepared using IFRS-IASB without reconciliation to US GAAP if the acquired business would qualify to use IFRS-IASB if it were a registrant.

Current rule	SEC's proposal
Requires the financial statements of an acquired foreign business that are prepared using accounting other than US GAAP or IFRS-IASB[10], such as home country GAAP, to be reconciled to US GAAP.	Would permit foreign private issuers that prepare their financial statements using IFRS-IASB to reconcile the acquired business's financial statements prepared using home country GAAP to IFRS-IASB rather than US GAAP.

KPMG observation

The proposed rule intends 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 companies.

Depending on the circumstances, the audit reports of acquired businesses filed with the SEC should refer to the standards of the PCAOB, US GAAS, both the PCAOB and US GAAS or both US GAAS and home-country (or international) GAAS. The independent public accounting firm issuing the report should be registered with the PCAOB.[11] This may create operational challenges and limit the cost savings if the financial statements were initially audited using only the International Standards on Auditing and subsequently were required to be audited using PCAOB or US GAAS standards.

Smaller reporting companies and issuers relying on Regulation A

The SEC has proposed amendments to Rule 8-04, which directs companies to Rule 3-05 for significance testing and thresholds. Form and content requirements would remain unchanged. Because Part F/S of Form 1-A refers to Rule 8-04, the proposed revisions to Rule 8-04 would apply to issuers relying on Regulation A.

As a result, under the proposed amendments, smaller reporting companies would continue to be required to provide up to two years of financial statements. Regulation A issuers would continue to be permitted to present the applicable periods.

Oil and gas producing activities

Under the proposed rule, current practice would be codified for significant acquired businesses that include significant oil- and gas-producing activities, including providing disclosures[12] on an unaudited basis for each full year of operations presented for the acquired business. It would permit companies to provide abbreviated financial statements if certain conditions are met.

10 International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB).

11 International Reporting and Disclosure Issues in the Division of Corporation Finance

12 ASC 932, Extractive Activities—Oil and Gas

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