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Client Alert

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SEC Amends Financial Disclosure Requirements for Acquisitions and Dispositions

On May 21, 2020, the SEC adopted a final rule amending the financial disclosure requirements relating to the acquisition and dispositions of businesses (collectively, the “amendments”). The amendments, which generally are consistent with the rule amendments proposed by the SEC in May 2019, are intended to reduce the costs and complexity of required financial disclosures pursuant to the SEC’s legislative mandate under the FAST Act. This Client Alert sets forth a general summary of the amendments, followed by industry-specific sections that may be of particular interest for our friends and clients in the REIT and Oil & Gas industries. Compliance with the new rules becomes mandatory on January 1, 2021, but voluntary early adoption is permitted so long as the amendments are adopted in their entirety.

Modifications to the “Significance Tests”

A number of SEC rules require a public company to determine whether an acquisition, a disposition, an equity method investee or a subsidiary is “significant” to the public company. Rule 1-02(w) of Regulation S-X sets forth three tests for assessing “significance”: the asset test, the investment test and the income test. The amendments revise the investment test and the income test with respect to acquisitions and dispositions. No substantive revisions were made to the asset test.

Investment Test

Before giving effect to the amendments, the investment test divides the public company’s investment in and advances to the acquired business (i.e., the numerator) by the company’s total assets as shown on the public company’s last audited balance sheet (i.e., the denominator). The new rules revise the numerator to provide that the investment generally includes debt assumed by the acquirer and any contingent consideration. More importantly, the amendments revise the denominator to be the “aggregate worldwide market value” of the public company’s voting and non-voting common stock based on the last five trading days of the most recently completed month prior to the earlier of the public company’s announcement of the transaction or the date of the agreement contemplating the acquisition or disposition. If the public company does not have a market value, the investment test will continue to reflect the public company’s total assets.

Income Test

Before giving effect to the amendments, the income test divides the target’s income from continuing operations before taxes, extraordinary items and the cumulative effects of changes in accounting principles for the most recently completed fiscal year (i.e., the numerator) by that of the acquirer (i.e., the denominator). The amendments add a new revenue prong to the numerator. The income test is not met unless two different calculations both exceed the applicable threshold: (i) pre-tax income of the target divided by pre-tax income of the public company and (ii) the target’s consolidated revenue from continuing operations (after intercompany eliminations) divided by the public company’s consolidated revenue for the most recently completed fiscal year. In order to meet the income test after the amendments, the target must meet both the revenue and the net income portions of the income test, and

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the lower result of the income test and the revenue test determines whether financial statements are required and, if so, the periods required to be presented.

In addition, when calculating significance under the income test, a public company with income for its last fiscal year that is 10% less than its five-year average income is permitted to use its five-year average income instead of the prior-year income as the denominator in order to moderate the effects of volatility. To calculate the average, existing rules require the use of zero for a year with negative net income in the five-year averaging period. The amendments permit a public company to use the absolute value of any loss in determining the average, thereby resulting in a larger denominator and decreasing the likelihood of tripping the significance threshold under the income test. This change may be particularly beneficial for many REITs and Oil & Gas companies expecting losses for the current fiscal year.

Expanding the Use of Pro Forma Financial Statements When Testing "Significance"

If a public company has completed a significant acquisition after the public company's last fiscal year and has filed Rule 3-05 financial statements with accompanying pro forma financial statements on a Current Report on Form 8-K, the public company is permitted to use pro forma, rather than historical, financial statements to calculate significance for future acquisitions. The amendments allow a public company to calculate significance based off of previously filed pro forma financial statements that reflect significant acquisitions and dispositions after the public company's last fiscal year end if the public company has filed (i) Rule 3-05 or 3-14 financial statements for the significant acquisitions or dispositions, and (ii) pro forma financial statements for any such acquired or disposed business. Under the amendments, the pro forma adjustments must be limited to the amounts combining the historical financial statements of the public company and the significant acquisition, together with the applicable Transaction Accounting Adjustments, but may not give effect to Autonomous Entity Adjustments or Management's Adjustments, each as discussed under "Pro Forma Financial Information" below. Once the public company uses pro forma financial information to measure significance, it must continue to use pro forma information to measure significance for future acquisitions until the filing of its next 10-K.

Periods to be Presented

The amendments eliminate the requirement to file a third year of audited financial statements, as reflected in the table below:

Significance ("S")	**Financial Statements Required**	
	Current Rules	**After the Amendments**
S < 20%	No financial statements required.	No financial statements required.
20% ≤ S < 40%	One year of audited financial statements and unaudited financial statements for most recent interim period and the corresponding prior-year interim period.	One year of audited financial statements, and unaudited financial statements for the most recent interim period (no comparative prior-year interim period required). Separate financial statements of a target that has been included in post-acquisition results for nine months may be omitted.
40% ≤ S < 50%	Two years of audited financial statements and unaudited financial statements for the most recent interim period and the corresponding prior-year interim period.	Two years of audited financial statements and unaudited financial statements for the most recent interim period and the corresponding prior-year interim period. Separate financial statements of a target that has been included in post-acquisition results for one year may be omitted.
50% ≤ S	Three years of audited financial statements, and unaudited financial statements for the most recent interim period and the corresponding prior-year interim period.	Two years of audited financial statements, and unaudited financial statements for the most recent interim period and the corresponding prior-year interim period. Separate financial statements of a target that has been included in post-acquisition results for one year may be omitted.

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The amendments do not apply to target company financial statements required to be included in a proxy statement or registration statement on Form S-4 or Form F-4, meaning that three years of historical financial statements for a target company still could be required in a transaction subject to a shareholder vote. As a result, it will be important to remember the potential requirement for three years of historical financial statements when negotiating a purchase agreement that will require stockholder approval.

Pro Forma Financial Information

The amendments replace the current pro forma regime set forth in Article XI of Regulation S-X with two categories of required pro forma adjustments, together with the optional new Management's Adjustments:

- *Transaction Accounting Adjustments (required)*: Transaction Accounting Adjustments will reflect the application of the U.S. GAAP (or IFRS) accounting. Adjustments to the pro forma income statement must be made notwithstanding whether a pro forma balance sheet is required. In addition, the amendments require a table showing the total consideration transferred or received, including a description of any contingent consideration. If the transaction accounting has not been completed, a prominent statement to this effect and a description of certain related information will be required.

- *Autonomous Entity Adjustments (required)*: Autonomous Entity Adjustments are those adjustments necessary to reflect the operations and financial position of an acquisition as an autonomous entity if it was previously part of another entity.

- *Management's Adjustments (optional)*: Management's Adjustments are encouraged to be included if, in management's opinion, additional adjustments are necessary to enhance an understanding of the effects of the transaction, including synergies and dis-synergies of the acquisition or disposition. Management's Adjustments may only be presented if certain conditions are met.

Transaction Accounting Adjustments and Autonomous Entity Adjustments must be presented in separate columns in the pro forma financial statements. Any Management's Adjustments must be presented in the notes to the pro forma financial statements in the form of reconciliations of pro forma net income and related pro forma earnings per share data after giving effect to such Management's Adjustments. Furthermore, the amendments require Management's Adjustments to be updated when the relevant pro forma financial statements are subsequently incorporated into a registration statement or other SEC filing.

It remains to be seen to what extent public companies will avail themselves of the flexibility afforded by Management's Adjustments. Any forward-looking information included in Management's Adjustments will be covered by the safe harbors under Rule 175 under the Securities Act and Rule 3b-6 under the Exchange Act. However, public companies may be reluctant to include Management's Adjustments in pro forma financial statements given the inherently unknowable outcomes of transaction synergies and dis-synergies and the potential need to update previously filed pro forma financial statements in future SEC filings in order to show Management's Adjustments as of the most recent practicable date, which would result in additional administrative cost.

Other Highlights

Dispositions

The amendments raise the significance threshold for significant dispositions from 10% to 20%.

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Investment Companies

The amendments add a definition of "significant subsidiary" specific to investment companies under the Investment Company Act. In addition, the rules add a new Rule 6-11, amend Form N-14 to cover financial reporting for fund acquisitions by investment companies and business development companies, and alter the current pro forma financial information requirements for investment companies.

Component Financials

The amendments provide for abbreviated financial statement requirements where the target consists of a component of an entity for which separate historical financial statements were never prepared, assuming certain qualifying conditions are met.

Foreign Private Issuers

Under the amendments, if the acquirer is a foreign private issuer that prepares its financial statements in accordance with IFRS, financial statements of a target that is a "foreign business" may be prepared using accounting principles other than U.S. GAAP or IFRS, so long are they are reconciled to IFRS. For a target that is not a "foreign business," but would qualify as a foreign private issuer if it were a public company, financial statements may be prepared using IFRS without reconciliation to U.S. GAAP, or, if the acquirer is a foreign private issuer that prepares its financial statements using IFRS, the target's financial statements may be prepared using accounting principles other than U.S. GAAP or IFRS and then must be reconciled to U.S. GAAP or IFRS.

Smaller Reporting Companies/Reg. A Offerings

The amendments generally make conforming changes to the financial statement presentation requirements for smaller reporting companies set forth in Article 8 of Regulation S-X, other than the form and content requirements for such financial statements, which will continue to be prepared in accordance with existing rules. Certain of these revisions are also applicable to issuers relying on Regulation A because Part F/S of Form 1-A refers to Rule 8-05.

Aggregation of Individually Insignificant Acquisitions

The amendments eliminate the requirement to provide pre-acquisition historical financial statements for individually insignificant acquisitions. Instead, when the aggregate significance of individually insignificant acquisitions exceeds 50%, the public company may provide pro forma financial information depicting the aggregate effects of all such individually insignificant acquisitions. In the adopting release for the amendments, the SEC addressed concerns as to whether accountants would be able to provide negative assurance to underwriters on the combined pro forma financial information by noting that, in some circumstances, accountants might need to perform additional work to meet the "reasonable investigation" and "reasonable care" due diligence standards of the Securities Act. However, the SEC declined to clarify how this additional work might be performed. In our experience, some accountants may be reluctant to provide any negative assurance over aggregated pro forma financial information for which they were not engaged to prepare or over which they previously performed procedures. It remains to be seen whether market practice ultimately will lead to greater willingness by underwriters and their counsel to self-diligence these aggregated pro forma adjustments.

Special Considerations for REITs

Generally, the amendments seek to harmonize the requirements set forth in Rule 3-05 and Rule 3-14, which have become increasingly divergent since the original adoptions of such rules. Specifically, the amendments:

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- align the Rule 3-14 significance threshold for individual acquisitions to 20%;
- align the Rule 3-14 significance threshold for the aggregation of individually insignificant acquisitions to 50%;
- eliminate the requirement to provide three years of financial statements for acquisitions from related parties;
- expressly permit the filing of financial statements covering a period of nine to 12 months to satisfy the requirement for filing financial statements for a period of one year for an acquired or to be acquired real estate operation;
- amend Rule 3-14 to include the same period for the filing of Rule 3-14 financial statements in registration statements and proxy statements as required by Rule 3-05; and
- eliminate the requirement to include Rule 3-14 financial statements in registration statements and proxy statements once the acquired real estate operation has been reflected in filed post-acquisition public company financial statements for a complete fiscal year.

The amendments also revise Rule 3-14 to require the use of a modified investment test when determining whether an acquisition is "significant" since the use of the asset or income tests generally is not practical for a real estate operation.

The new investment test may be less accommodative for public companies trading at a discount to book value, which, under current market conditions, generally includes most REITs. For a REIT trading at a discount to book value, using the REIT's market capitalization as the denominator will decrease the net benefit of the increased 20% threshold for individually significant acquisitions, and for a REIT trading at less than 50% book value, the revisions to the investment test and the significance threshold when viewed collectively potentially result in more burdensome financial reporting obligations.

The amendments revise Form 8-K to require disclosure and financial statements of a significant disposition that constitutes a real estate operation for purposes of Rule 3-14. While equity REITs generally do not dispose of properties regularly, the need to prepare financial statements for individually significant dispositions is noteworthy.

Under current rules, accountants auditing Rule 3-14 financial statements need not be independent. The amendments require that auditors of Rule 3-14 financial statements be subject to the independence criteria set forth in Regulation S-X.

Under current SEC policy, when a REIT has triple-net leased one or more real estate properties to a single lessee and such properties represent a significant portion of the REIT's assets, the financial statements of the lessee (rather than the REIT) may be provided in lieu of the financial statements otherwise required by Rule 3-14. The amendments eliminate this accommodation, which will have wide-ranging effects for REITs with triple-net lease and related business models, as property sellers in these industries often do not maintain the books and records necessary to prepare audited financial statements for the acquired property.

The amendments will require large swathes of the SEC's Financial Reporting Manual to be revised, substantial portions of which are currently dedicated to REIT financial statement requirements, which may have additional implications for REITs beyond those set forth in the amendments.

Finally, the amendments revise Rule 3-14 to define a "real estate operation" (i.e., an acquisition for which Rule 3-14 is applicable rather than Rule 3-05) as "a business that generates substantially all of its revenues through the leasing of real property." While the adopting release for the amendments notes that the revised definition is intended to be consistent with current practice and SEC Staff interpretations, the adopting release expressly notes that the amendments do not define what is meant by "substantially all" for purposes of the new definition, as the application of the definition will depend on specific facts and circumstances. The continued ambiguity over the term "substantially all" may have implications for REITs

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that derive a portion of their income from non-leasing activities, potentially including REITs that own and operate traditional midstream infrastructure assets (see our prior Client Alert on this topic *available here*).

Special Considerations for the Oil & Gas Industry

For acquisitions of a business that includes "significant oil-and gas-producing activities," the amendments formally adopt the SEC's practice of allowing public companies to provide certain abbreviated industry-specific presentations set forth in FASB ASC Topic 932, thereby eliminating the need to submit a formal no-action request in certain situations. Many oil and gas acquisitions are structured as asset purchases of producing and non-producing properties and, as a result, the targets have no historical audited financial statements. The amendments allow these public companies to provide an audited statement of revenues and direct operating expenses instead of a full income statement and balance sheet, assuming certain conditions are met. In addition, the amendments require public company issuers to include proved reserve and standardized measure disclosures along with the historical target company financial statements.

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