

SEC Amends Financial Statement Requirements for Business Acquisitions and Dispositions

Article By:

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In May 2020, the US Securities and Exchange Commission announced amendments to the rule and forms regarding the financial statement requirements for business acquisitions and dispositions. Among other benefits, the amendments are intended to improve the quality of financial information regarding acquired or disposed businesses for investors, facilitate more timely access to capital, and reduce the complexity and costs to prepare the disclosure for registrants. This article takes a close look at the new amendments, which go into effect on January 1, 2021 (although voluntary compliance will be permitted in advance of the effective date).

IN DEPTH

On May 21, 2020, the US Securities and Exchange Commission (SEC) announced amendments to the rules and forms regarding the financial statement requirements for business acquisitions and dispositions ([SEC Release No. 33-10736 \(May 20, 2020\)](#)). The SEC specifically adopted amendments to Rules 3-05, 3-14, 8-04, 8-05 and 8-06 and Article 11 under Regulation S-X, as well as to other related rules and forms. In connection with these changes, the SEC also amended the significance tests in the “significant subsidiary” definition under Rule 1-02(w) of Regulation S-X, Securities Act Rule 405 and Exchange Act Rule 12b-2.

Generally, the amendments will not affect the financial statements related to a target business that is the subject of a proxy statement or registration statement on Form S-4 or F-4. However, in certain circumstances, application of the amended significance tests may affect whether the financial statements of a target business that is not an Exchange Act reporting company are required to be included in such a proxy statement or registration statement. The amendments also do not affect the requirements in Rules 3-02 or 8-01 of Regulation S-X relating to predecessor companies.

In addition, the SEC adopted new requirements regarding fund acquisitions specific to registered investment companies and business development companies. (The amendments pertaining to investment companies and business development companies, as well as oil and gas producing activities, are beyond the scope of this client alert.)

The amendments are intended to improve the quality of financial information regarding acquired or disposed businesses for investors and to facilitate more timely access to capital and reduce the

complexity and costs to prepare the disclosure for registrants. The amendments also will assist registrants in making more meaningful determinations of whether a subsidiary or an acquired or disposed business is significant, and improve the financial disclosure requirements applicable to acquisitions and dispositions of businesses, including real estate operations and investment companies. The amendments will be effective on January 1, 2021, but voluntary compliance will be permitted in advance of the effective date.

Background

When a registrant acquires a significant business, other than a real estate operation, Rule 3-05 of Regulation S-X (Rule 3-05) generally requires a registrant to provide separate audited annual and unaudited interim pre-acquisition financial statements of that business. (Rule 3-14 of Regulation S-X (Rule 3-14) addresses the unique nature of real estate operations and requires a registrant that has acquired a significant real estate operation to file financial statements with respect to such acquired operation.) The number of years of financial information that must be provided depends on the relative significance of the acquisition to the registrant. Significance is determined by applying the investment test, the asset test and the income test under Rule 1-02(w) of Regulation S-X, and an acquired business is significant if it is significant under any of these tests.

Article 11 of Regulation S-X (Article 11) also requires registrants to file unaudited *pro forma* financial information relating to the acquisition or disposition of a business. *Pro forma* financial information typically includes a *pro forma* balance sheet and *pro forma* income statements based on the historical financial statements of the registrant and the acquired or disposed business, including adjustments to show how the acquisition or disposition might have affected those financial statements.

Significance Tests

The final rules amend the significance tests under Rule 1-02(w) for determining whether a registrant is required to provide the historical financial statements of a business the registrant acquires and, if so, how many periods must be presented. More specifically, the amendments revise the calculation of significance under the investment test and the income test while leaving the asset test substantively unchanged. (Under the current asset test, an acquisition is significant if the registrant's share of the target business's total assets exceeds 20% of the registrant's consolidated total assets as of the end of the most recently completed fiscal year.)

Investment test

Under the current investment test, an acquisition is significant if the registrant's investment in the target business exceeds 20% of the registrant's total assets as of the end of the most recently completed fiscal year. The amended investment test, however, aligns itself more closely with the economic significance of the acquisition to the registrant by comparing the registrant's investment in the target business to the aggregate worldwide market value of the registrant's voting and non-voting common equity, when available. Aggregate worldwide market value (which includes common equity held by affiliates) will be averaged over the last five trading days of the registrant's most recently completed month ending prior to the earlier of the registrant's announcement date or agreement date of the acquisition or disposition. Where a registrant does not have an aggregate worldwide market value, the current investment test will apply.

Income test

Under the current income test, an acquisition is significant if the registrant's equity in the target business's income from continuing operations before taxes, extraordinary items and cumulative effects of changes in accounting principles exceeds 20% of such income of the registrant for the most recently completed fiscal year. As a result, the current income test produces inconsistent results because it focuses only on net income, which can include non-recurring expenses, gains and losses. The amended income test, however, adds a new revenue component, which compares the target business's revenue to the registrant's revenue. In order to satisfy the revised income test, the target business must meet both the revenue component and the net income component and, for purposes of the application of Rule 3-05, may use the lower of the revenue component or the net income component to determine the number of periods for which Rule 3-05 financial statements are required. Where either the registrant or the target business do not have recurring annual revenues in each of the two most recently completed fiscal years, only the net income component will apply.

Financial Statements Required to be Included for Significant Acquisitions

Under the current rules, Rule 3-05 financial statements may be required for up to three years depending on the relative significance of the acquired or to-be acquired business. The amendments, however, reduce the number of years of required Rule 3-05 financial statements from three years to up to two years for more significant acquisitions (*i.e.*, significance level of 50% or higher). The SEC indicated that two years of pre-acquisition financial statements is sufficient to enable investors to understand the possible effects of the acquired business on the registrant. The SEC also indicated that older financial statements can be less relevant for evaluating an acquisition because they are less likely to be indicative of the current financial condition, changes in financial condition and results of operations of the acquired business due to their age.

The chart below summarizes the current requirements and the amended requirements:

Significance Level	Current Requirements	Amended Requirements
20% or less	No financial statements required.	No financial statements required.
Greater than 20% but less than or equal to 40%	Financial statements for the most recent fiscal year (audited) and the latest required interim period (unaudited) that precedes the acquisition, and the corresponding interim period of the preceding year (unaudited).	Financial statements for the most recent fiscal year (audited) and the most recent interim period (unaudited). Eliminates the need to provide a comparative interim period.
Greater than 40% but less than or equal to 50%	Financial statements for the two most recent fiscal years (audited) and the latest required interim period (unaudited) that precedes the acquisition, and the corresponding interim period of the preceding year (unaudited).	Financial statements for the two most recent fiscal years (audited) and the latest required interim period (unaudited) that precedes the acquisition, and the corresponding interim period of the preceding year (unaudited).
Greater than 50%	Financial statements for the three most recent fiscal years (audited) and the latest required interim period (unaudited) that precedes the acquisition, and the corresponding interim period of the preceding year.	

Abbreviated Financial Statements

Registrants sometimes acquire an asset or component of an entity that is a “business” as defined in Rule 11-01(d) of Regulation S-X but does not constitute a separate entity, subsidiary or division. Such a business may not have separate financial statements or maintain separate and distinct accounts necessary to prepare Rule 3-05 financial statements because it often represents only a small portion of the selling entity. As a result, registrants in the past have sought relief from the SEC or relied on informal guidance to provide in such situations abbreviated financial statements (*i.e.*, audited statements of assets acquired and liabilities assumed, as well as statements of revenues and expenses that exclude allocations of certain corporate overhead, interest and income tax expenses).

The amendments add new rule Rule 3-05(e), which allows registrants to provide abbreviated financial statements if all of the following requirements are satisfied:

- The total assets and total revenues (both calculated after intercompany eliminations) of the acquired or to-be acquired business constitute 20% or less of such corresponding amounts of the seller and its subsidiaries, consolidated as of and for the most recently completed fiscal year.
- The acquired business was not a separate entity, subsidiary, operating segment (as defined in US GAAP or IFRS-IASB, as applicable) or division during the periods for which the acquired business’s financial statements would be required.
- 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 may not exclude from the abbreviated financial statements certain items, including interest expense for debt assumed from the seller or various operating expenses paid by or on behalf of the business during the pre-acquisition period (*e.g.*, selling, distribution, marketing, general and administrative, and research and development, and depreciation and amortization expenses).

Omission of Acquired Business Financial Statements

Rule 3-05 financial statements currently are not required to be included in a registration statement or proxy statement once the operating results of the target business have been reflected in the audited consolidated financial statements of the registrant for a complete fiscal year, unless (1) the financial statements have not been previously filed (which is often the case for a company that has recently completed an IPO) or (2) even if previously filed, the acquired business is of major significance (*i.e.*, significance level of 80% or higher). The amendments, however, no longer require Rule 3-05 financial statements in registration statements and proxy statements once the target business is reflected in the registrant’s audited post-acquisition financial statements for nine months, if the significance of the target company is greater than 20% but less than or equal to 40% percent, for a complete fiscal year. The amendments also eliminate the requirement to provide financial statements when they have not been previously filed or when they have been filed but the acquired business is of major significance.

Individually Insignificant Acquisitions

Currently, if a registrant acquires unrelated businesses that are not individually significant but that together would exceed 50% significance, the registrant must file historical audited financial statements and related *pro forma* financial information for those businesses constituting the mathematical majority of the group. (A “mathematical majority” refers to those businesses constituting more than 50% of the relevant significance test under which the businesses were determined to be significant in the aggregate.) The amendments still require *pro forma* financial information regarding the aggregate effects of all such acquisitions that together exceed 50% significance, but historical financial statements only will be required for those businesses whose individual significance exceeds 20% (but are not yet required to file financial statements).

Pro Forma Financial Information

Dispositions

Pro forma financial information currently is required upon the disposition or probable disposition of a significant portion of a business either by sale, abandonment or distribution to shareholders by means of a spin-off, split-up or split-off, if that disposition is not fully reflected in the financial statements of the registrant. A disposition of a business currently is considered significant if it meets the conditions of a significant subsidiary under Rule 1-02(w), using a 10% significance threshold. The amendments, however, will raise the significance threshold from 10% to 20% to match the threshold for acquisition significance. In addition, the tests used to determine significance of a disposed business will be conformed to those used to determine significance of an acquired business.

Measuring Significance

Currently, significance determinations are required to be made by comparing the most recent annual financial statements of the target business to those of the registrant prior to the date of the acquisition. A registrant, however, is permitted under the final rules to use *pro forma*, rather than historical, financial information to determine significance if the registrant has made a significant acquisition subsequent to the last fiscal year and has filed the target business's historical financial statements and *pro forma* financial information on a Form 8-K.

The amendments also allow registrants to measure significance using filed *pro forma* financial information if the registrant has made a significant disposition subsequent to the last fiscal year and *pro forma* information has been filed for the disposition. In addition, the amendments permit the use of such *pro forma* information for significance testing in IPOs. However, once a registrant uses *pro forma* financial information to measure significance, the registrant must continue to use *pro forma* financial information until its next annual report.

Modifications to Form and Content

The final rules amend the *pro forma* financial information requirements to improve the content and relevance of such information. More specifically, the revised *pro forma* adjustment criteria will provide for the following:

- “Transaction Accounting Adjustments” reflecting only the application of required accounting to the transaction

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- “Autonomous Entity Adjustments” reflecting the operations and financial position of the registrant as an autonomous entity if the registrant was previously part of another entity
 - Optional “Management’s Adjustments” depicting synergies and dis-synergies of the acquisitions and dispositions for which *pro forma* effect is being given if, in management’s opinion, such adjustments would enhance an understanding of the *pro forma* effects of the transaction and certain conditions related to the basis and the form of presentation are met.

Foreign Businesses

The amendments modify Rule 3-05(c) to permit foreign private issuers that prepare their financial statements using IFRS-IASB to reconcile Rule 3-05 financial statements prepared using home country GAAP to IFRS-IASB rather than US GAAP. This will provide more comparable financial information and better facilitate the analysis of the financial statements. In addition, Rule 3-05(d) will now permit Rule 3-05 financial statements to be prepared in accordance with IFRS-IASB without reconciliation to US GAAP if the acquired business would qualify as a foreign private issuer if it were a registrant itself.

Smaller Reporting Companies and Issuers Relying on Regulation A

The amendments make corresponding changes, other than for the form and content requirements for the financial statements, to the smaller reporting company requirements under Article 8 of Regulation S-X, which also apply to issuers relying on Regulation A. The final rules amend Rule 8-01 to permit the application of Rule 3-06, which generally allows financial statements covering a period of nine months to satisfy the Rule 3-05 requirement for filing financial statements for a period of one year. Rule 8-04 will continue to require up to two years of acquired business historical financial statements and permit smaller reporting companies to omit the financial statements if the acquired business has been included in the registrant’s operations for a complete fiscal year. The final rules also amend Form 8-K and Article 8 to require smaller reporting companies to provide *pro forma* financial information for disposition of a significant business in Form 8-K and in certain registration statements and proxy statements when the disposition occurs during or after the most recently completed fiscal year. In addition, the final rules amend Rule 8-05 to require that the preparation, presentation and disclosure of *pro forma* financial information by smaller reporting companies substantially comply with Article 11.

Real Estate Operations

Rule 3-14 currently differentiates real estate operations from other businesses and requires a registrant that has acquired a significant real estate operation to file financial statements with respect to such acquired operation. The amendments, however, align Rule 3-14 with Rule 3-05 where no unique industry considerations exist and clarify the application of Rule 3-14 regarding (1) the determination of significance, (2) the need for interim income statements, (3) special provisions for blind pool offerings and (4) the scope of the rule’s requirements.

Effectiveness and Voluntary Compliance

Registrants will not be required to apply the amendments until the beginning of the registrant’s fiscal year beginning after December 31, 2020 (the “mandatory compliance date”). Acquisitions and

dispositions that are probable or consummated after the mandatory compliance date must be evaluated for significance using the amendments. For initial registration statements, registrants are not required to apply the amendments until the initial registration statement is first filed on or after the mandatory compliance date, at which point, all probable or consummated acquisitions and dispositions, including those consummated prior to the mandatory compliance date, must be evaluated for significance using the amendments.

Voluntary early compliance is permitted in advance of the mandatory compliance date provided that the amendments are applied in their entirety from the date of early compliance. The SEC also clarified that for an acquisition or disposition of a business for which the disclosure required by an Item 2.01 Form 8-K has been filed (or was required to be filed) prior to the mandatory compliance date (or the voluntary early compliance date, if applicable), but for which Rule 3-05 financial statements and Article 11 *pro forma* financial information are not required to be filed (e.g., in an Item 9.01 Form 8-K) until after the mandatory compliance date (or until after the voluntary early compliance date, if applicable), the registrant must file the financial statements and *pro forma* financial information required by the rules in effect when the Item 2.01 Form 8-K was required to be filed.

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