Capital Markets Alert
May 2020

SEC Amends Financial Statement Requirements Regarding Business Acquisitions and Dispositions

Update Intended To Result in More Meaningful Presentations

Securities and Exchange Commission (SEC) rules require financial statements and other disclosures in current and periodic Exchange Act reports and in certain Securities Act registration statements when a reporting company acquires or disposes of a significant business. The SEC recently adopted changes to these rules to simplify and clarify their application as well as to improve usefulness of the disclosures to investors.

Three tests of significance must be used to determine whether the disclosure requirements are triggered—the investment test, the asset test and the income test. If any test is exceeded, disclosure is required.

Currently, the investment test compares the purchase price of a business acquired or disposed of with the total amount of the reporting company's assets on the balance sheet, mismatching the market value of the target with the historical prices at which the company acquired its other assets. The amendments remedy this anomaly by substituting current worldwide market value of the issuer's equity for total assets in the denominator. In general, contingent consideration will be included in determining the target sale price.

The income test, at present, compares the income or loss from continuing operations before income taxes of the reporting company with that of the business being acquired or disposed of. Because of the volatility of income—including potential mismatches between income and loss periods—this measure does not always reflect the true significance to the reporting company of an acquisition or disposition of a business. The amendments add a revenue component to the income test—so disclosure pursuant to the income test is required only if both the income and revenue conditions of the test are exceeded—and clarifies how income and loss periods are treated.

Technical changes are made to all three tests. The asset test, comparing the balance sheet amounts of the tested business and the reporting company, is otherwise unchanged.

With certain exceptions, current rules require a reporting company to file audited financial statements of an acquired business for its previous fiscal year, or previous two or three fiscal years if the tests of significance are exceeded at the 20%, 40% or 50% levels. The new rules eliminate the third tier, so one year's financial statements are required if the 20% level is exceeded, and two years' statements are required if the 40% level is exceeded.

Attorney Advertising

Comparative interim financial statements will be required only in the latter case. Abbreviated financial statements are permitted for businesses that the seller had not separately accounted for if certain conditions are satisfied.

Under current rules, a reporting company is required to file pro forma financial information, including a balance sheet, as of its most recently ended fiscal period, and an income statement as of the beginning of the company's current fiscal year, giving effect to a business acquisition of at least the 20% level of significance or disposition of a business at the 10% level. The rules are amended to increase the disposition significance level to 20%. The amendments also substantially revise the format for presentation of pro forma financial information, including to allow management's reasonable expectations for synergies and other transaction effects to be reflected.

The new rules apply to transactions consummated or probable of consummation after the first day of a company's fiscal year beginning after Dec. 31, 2020. Application of the amended rules to transactions completed earlier is permitted.

Related Professionals

David Fischer . . . . dfischer@loeb.com
Norwood Beveridge Jr. . . . . nbeveridge@loeb.com

This is a publication of Loeb & Loeb and is intended to provide information on recent legal developments. This publication does not create or continue an attorney client relationship nor should it be construed as legal advice or an opinion on specific situations.

© 2020 Loeb & Loeb LLP. All rights reserved.

6350 REV1 06-03-2020