

The SEC's Revised Regime for M&A Financial Disclosure

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Overview of Amendments

- **A public company acquiror must comply with SEC financial disclosure requirements for acquired businesses**
 - **Post-closing 8-K:** Depending on the “significance” of the acquired business relative to the acquiror, the acquiror might be required to file historical acquired business financial statements and pro forma information
 - **Securities offerings:** Acquired business financial statements and pro forma information may be required in registration statements, in some cases even before the closing of the M&A transaction
- **On May 21, 2020, the SEC adopted amendments to—on balance—relax the financial disclosure requirements in the M&A context,¹ with the goal of harmonizing the burden and benefit of preparing such disclosures; the amendments largely track the initial SEC proposals but include some notable improvements, including some recommended in Cravath's comment letter**
- **Notably, the amendments**
 - revise the **significance tests** used to determine if acquired business financial statements and pro forma information will be required and for what periods, by
 - using an acquiror's “worldwide market value” instead of the book value of its total assets in the investment test, and
 - adding a revenue component to the income test;
 - expand the use of pro forma information in calculating significance;
 - limit the periods to be presented for acquired business financial statements to **no more than the two most recent fiscal years** (vs. three), even at the highest significance level, as well as any required interim period;
 - permit **abbreviated financial statements** for certain acquisitions of a component business of a seller;
 - for a significant series of “**individually insignificant**” acquisitions, reduce the burden of providing separate acquired business financial statements while expanding the scope of required pro forma information;
 - establish three categories of **pro forma adjustments**:
 - **mandatory** transaction accounting and autonomous entity adjustments, and
 - **optional** management's adjustments depicting synergies and dis-synergies

(1) As a general matter, these amendments do not directly affect the acquired business financial statements required in an S-4 registering securities offered as consideration to target shareholders. Those requirements arise from Form S-4 (which was not amended) and remain the same except to the extent indirectly altered by the application of the revised significance tests.

Revised Significance Tests

Significance Tests Generally

- The inclusion of acquired business financial statements in SEC filings and the periods required to be presented depend on the level of “significance” of the acquisition, which is measured through the following tests:

Test	Old Formulation	New Formulation
Investment Test	$\frac{\text{Purchase Price}}{\text{Book Value of Acquiror's Total Assets}}$	$\frac{\text{Purchase Price}}{\text{Acquiror's Aggregate Worldwide Market Value (if available)}}$
Income Test	$\frac{\text{Acquired Pre-Tax Income}}{\text{Acquiror's Pre-Tax Income}}$	$\frac{\text{Acquired Pre-Tax Income}}{\text{Acquiror's Pre-Tax Income}} \quad \text{AND} \quad \frac{\text{Acquired Total Revenue}}{\text{Acquiror's Total Revenue}}$ <p><i>lower result of two tests determines periods to be presented</i></p>
Asset Test	$\frac{\text{Acquired Total Assets}}{\text{Acquiror's Total Assets}}$	$\frac{\text{Acquired Total Assets}}{\text{Acquiror's Total Assets}}$

- An acquiror without a worldwide market value must use the old formulation of the investment test
- The new revenue component of the income test is unavailable for transactions in which either the acquiror or the acquired business did not have material revenue in each of their two most recently completed fiscal years
- The revised significance tests will also apply to several other instances outside of the M&A context, e.g., for determining the “significant subsidiaries” to be listed in exhibits to annual reports
 - The notable exception is that the new revenue prong in the income test will not be available to determine whether financial statements of equity method investees are required to be filed in certain circumstances

Revised Investment Test

Old Formulation	New Formulation
$\frac{\text{Purchase Price}}{\text{Book Value of Acquiror's Total Assets}}$	$\frac{\text{Purchase Price}}{\text{Acquiror's Aggregate Worldwide Market Value (if available)}}$

- **The revised investment test compares the acquiror's investment in the acquired business to the aggregate worldwide market value of the acquiror's voting and non-voting common equity ("aggregate worldwide market value")**
- **Numerator: investments in the acquired business**
 - In the M&A context, the numerator of the investment test will generally be the purchase price for the transaction
 - If **contingent consideration** is required to be recorded at fair value at the acquisition date under US GAAP or IFRS-IASB, such fair value must be included in the numerator as part of the purchase price. If not so required to be recorded, all contingent consideration must be included in the numerator—including sales-based milestones and royalties—if the likelihood of payment is more than remote
- **Denominator: acquiror's aggregate worldwide market value**
 - Calculated by **averaging** the daily aggregate worldwide market value for the last five trading days of the most recently completed month ending prior to the earlier of (1) the signing and (2) the announcement of the transaction
- **For combinations between businesses under common control, the amendments provide that the investment test is met when either**
 - the **book value** of the acquired business exceeds 10% of the acquiror's consolidated assets, or
 - the **number of common shares** exchanged by the acquiror exceeds 10% of its common shares outstanding
- **The revised investment test generally improves the efficacy of the test as a measure of economic significance, because both the numerator and denominator are now fair value measurements**
 - The test will be particularly more effective at capturing economic significance for acquirors who are "asset light" or own a relatively significant amount of intangible assets that are developed internally and recorded at cost

Revised Income Test

Old Formulation	New Formulation	
$\frac{\text{Acquired Pre-Tax Income}}{\text{Acquiror's Pre-Tax Income}}$	$\frac{\text{Acquired Pre-Tax Income}}{\text{Acquiror's Pre-Tax Income}}$	AND $\frac{\text{Acquired Total Revenue}}{\text{Acquiror's Total Revenue}}$
	<i>lower result of two tests determines periods to be presented</i>	

- The additional revenue component compares the acquired company's total consolidated revenue to the acquiror's total consolidated revenue for the most recently completed fiscal year
 - The new revenue component is not available if either the acquired business or the acquiror did not have material revenue in each of the **two** most recently completed fiscal years
- The income test is met at a particular significance level only if both the pre-tax income and revenue components are met
 - "Pre-tax income" refers to income or loss from continuing operations before income taxes
 - Once both components are met, the lower of the two resulting significance levels is used to determine the period of acquired business financial statements and pro forma information to be presented (assuming neither of the other two tests yields a higher significance level)

ILLUSTRATION

A Investment Test %	Income Test			C Asset Test %	max [A B C] Final Significance %
	B1 Pre-Tax Income Component %	B2 New Revenue Component %	B = min [B1 B2] Final Income Test %		
15	45	55	45	25	45
15	45	55	45	60	60
15	45	19	19	25	25

- The addition of the revenue component will provide a check on potential "false positives" associated with the pre-tax income component, particularly in the case of acquirors operating at or near breakeven
- The amendments also provide that absolute values of pre-tax income may be used for instances in which pre-tax income is negative, but otherwise leave the pre-tax income component largely unchanged
 - Notably, the SEC did not revise the income component to use after-tax income as previously proposed

Use of Pro Forma Information To Measure Significance

- **For registration statements, an acquiror may test the significance of an acquisition using financial statements that give pro forma effect to previously completed significant acquisitions consummated after its latest fiscal year end, if it has filed:**
 - the **required historical financial statements** for the previously acquired companies, and
 - the **required pro forma financial statements** in connection with the previous acquisitions
- **If an acquiror uses pro forma financial statements to measure significance, it must continue to do so for any subsequent acquisitions until its next annual report is filed**
- **When used to determine significance, pro forma figures (e.g., assets and pre-tax income) may not give effect to “autonomous entity adjustments” or “management’s adjustments”**
 - Only the transaction accounting adjustments (see slide 16) may be included for this purpose
 - Acquirors may therefore have to reproduce previously filed pro forma financial statements if such statements contained adjustments that would make them ineligible to be used to measure significance
- **Before the amendments, use of pro forma information was only permitted if the required historical and pro forma information for the previous acquisitions had been previously reported on an 8-K, and therefore was unavailable for IPO registration statements**
 - This change will provide IPO companies with more flexibility when measuring the significance of acquisitions, thereby easing their disclosure burden and facilitating access to the public markets

Presentation Matters

Acquired Business Financial Statements—Required Periods

Significance ¹ (one or more tests)	Old Rules	New Rules
≤ 20%	No historical or pro forma financial statements required	
> 20% and ≤ 40%	Audited financial statements for most recent fiscal year	
	Unaudited financial statements for most recent interim period and the corresponding prior year interim period	Unaudited financial statements only for most recent interim period (corresponding prior year interim period not required)
	Pro forma balance sheet as of date of the acquiror's most recent interim balance sheet and pro forma annual and interim income statements for the most recent fiscal year and interim period	
> 40% and ≤ 50%	Audited financial statements for two most recent fiscal years	
	Unaudited financial statements for most recent interim period and the corresponding prior year interim period	
	Pro forma balance sheet as of date of the acquiror's most recent interim balance sheet and pro forma annual and interim income statements for the most recent fiscal year and interim period	
> 50%	Audited financial statements for three most recent fiscal years	Audited financial statements for two most recent fiscal years
	Unaudited financial statements for most recent interim period and the corresponding prior year interim period	
	Pro forma balance sheet as of date of the acquiror's most recent interim balance sheet and pro forma annual and interim income statements for the most recent fiscal year and interim period	

(1) Refers to significance of individual acquisitions. The implications of significant series of individually insignificant acquisitions are discussed below.

Omission of Acquired Company Financial Statements

- **Under the new rules, an acquiror may omit acquired business financial statements from registration and proxy statements if the acquired business's results are included in the acquiror's audited post-acquisition results for**
 - **nine months**, in the case of acquisitions with significance levels more than 20% but not more than 40%, or
 - **one complete fiscal year**, in the case of acquisitions with significance levels more than 40%
- **The amendments eliminate the requirement to provide acquired business financial statements where the acquired business's results have been included in audited post-acquisition results for a full fiscal year but (1) they have not been previously filed or (2) the acquisition was of major significance¹**
- **This is another welcome change for IPO companies, who can now avoid the significant burden of including separate audited financial statements of older completed acquisitions in initial registration statements**
- **The SEC stressed while adopting these amendments that companies still have a general obligation at all times to provide any “further material information” as is necessary to make the financial disclosure, in light of the circumstances under which it was made, not misleading**

(1) Generally interpreted in practice as a 70-80% significance level or higher.

Foreign Acquired Businesses

- **Companies that qualify as foreign private issuers (“FPIs”) are permitted to present financial statements prepared using International Financial Reporting Standards as issued by the International Accounting Standards Board (“IFRS-IASB”) instead of US GAAP**
- **Under the old rules, acquirors generally had two options when required to file financial statements for acquired businesses not using US GAAP: (1) restate the financial statements using, or reconcile them to, US GAAP or (2) if the acquired business met the definition of a “foreign business,” file financial statements using IFRS-IASB**
- **These restrictions led to certain counterintuitive results**
 - If the financials of an acquired business were prepared using a basis other than US GAAP or IFRS-IASB, an FPI acquiror would need to restate the financial statements using, or reconcile them to, US GAAP, even though its own financial statements used IFRS-IASB
 - Certain acquired businesses met the definition of an FPI but not the definition of a “foreign business” (which requires majority ownership outside the United States in all cases). As such, their acquirors were not allowed to use IFRS-IASB to present acquired business financial statements even though the acquired business could use IFRS-IASB if it were itself a registrant
- **The amendments address these and other inconsistencies by:**
 - **permitting FPIs** who use IFRS-IASB to reconcile to IFRS-IASB (instead of US GAAP) the home-country GAAP financial statements of both (1) acquired “foreign businesses” and (2) acquired businesses that would meet the FPI definition
 - **permitting all acquirors** to present financial statements of acquired businesses prepared using IFRS-IASB if the acquired business would meet the FPI definition
- **The appendix to this presentation summarizes the various accounting standard options now available to acquirors when filing acquired business financial statements for acquired businesses not using US GAAP**

Individually Insignificant Acquisitions

- **As a general rule, acquired business financial statements and related pro forma information are not required for “individually insignificant” acquisitions, which come in three varieties**
 - An acquisition less than 20% significant (e.g., all acquisitions except Acquisition **E** below),
 - A probable acquisition less than 50% significant (e.g., Acquisition **F** below), and
 - A consummated acquisition less than 50% (but more than 20%) significant, and the registration / proxy statement is effective / mailed no more than 74 days following consummation (e.g., Acquisition **E** below)

ILLUSTRATION

“Individually insignificant” acquisitions since 2019 10-K, for a registration statement effective October 1, 2020				
	Date Consummated	Investment Test %	Asset Test %	Income Test %
Acquisition A	Jan. 2020	10	19	8
Acquisition B	Feb. 2020	10	7	6
Acquisition C	April 2020	11	6	5
Acquisition D	July 2020	13	11	5
Acquisition E	Aug. 2020	17	10	21
Acquisition F (probable)	N/A	9	6	4
		70	58	49

- **If the aggregate significance of a series of individually insignificant acquisitions since the date of an acquiror’s latest audited balance sheet exceeds 50%,**
 - **the old rules** required registration and proxy statements to include acquired business financial statements (and corresponding pro forma information) for at least the substantial majority of the individually insignificant acquisitions
 - **the new rules** require registration and proxy statements to include separate acquired business financial statements for only those acquisitions whose individual significance exceeds 20% and pro forma information showing aggregate effects of all individually insignificant acquisitions in all material respects

ILLUSTRATION

Required financial disclosure for a registration statement effective October 1, 2020		
	Old Rules	New Rules
Historical	For each of any four acquisitions (or any three including Acquisition E) ¹	For Acquisition E
Pro forma	For the combination chosen above	Aggregate effects of Acquisitions A through F in all material respects

(1) In practice, the “substantial majority” standard has been interpreted as requiring any combination of individually insignificant acquisitions adding up to a percentage in excess of the mathematical majority of the aggregate significance for the entire series. Here, that aggregate significance is 70% (under the investment test), so the substantial majority standard is met above 35%.

“Individually Insignificant” Acquisitions—*Cont’d*

- **As a practical matter, acquirors who anticipate going to market at a time when the aggregate significance of “individually insignificant” acquisitions may exceed 50% should**
 - negotiate for delivery of target historical financial information for acquisitions less than 50% (but more than 20%) significant **earlier** than they would otherwise require under the old rules,
 - negotiate for the timely provision of target financial information for each acquisition necessary to present pro forma financial information depicting the aggregate effects of all such acquisitions in all material respects, and
 - proactively engage with auditors to ensure **adequate negative assurance comfort** on pro forma financial information, which under the new rules is more likely to include unaudited or unreviewed components (given the permitted absence of acquired business financial statements in these circumstances)

Abbreviated Financial Statements for Components

- **When an acquired business represents a relatively small component of the seller, and the seller has not maintained distinct accounts for the business (such as a particular product or business spread across segments, divisions or subsidiaries), the amendments allow acquirors to provide abbreviated acquired business financial statements, eliminating the need to make certain allocations**
- **Certain conditions must be satisfied in order to present abbreviated financial statements under the new rule**
 - “**Qualifying conditions**” relating to the historical accounting and other features of the component business. Examples include
 - The total assets and total revenues (both after intercompany eliminations) of the component business must constitute 20% or less of the corresponding consolidated amounts of the seller as of and for the most recently completed fiscal year,
 - The seller must not have maintained separate accounts for the component business that included the expenses permitted to be omitted, and
 - Separate financial statements for the component business must not have previously been prepared
 - “**Presentation conditions**” relating to the presentation of the abbreviated financial statements. Examples include
 - The income statement must not omit distribution, marketing, SG&A or R&D expenses
 - The notes to the financial statements must include specifically enumerated disclosures, including the types of omitted expenses and an explanation of the impracticability of preparing financial statements that include the omitted expenses
- **Contrast with “carve-out” financial statements**
 - The SEC was careful to clarify that the new rule does not address “carve-out financial statements,” which it defined as a generic term used to describe separate financial statements derived from the financial statements of a larger parent company
 - The adopting release differentiates carve-out financial statements as those for which reasonable allocations of corporate overhead expenses can be made (such that the underlying issues involve the *scope* of the businesses to be included, not *whether* financial statements can be prepared)
- **The new rule reflects market practice for the acquisition of component businesses based on ad hoc exemptive relief from the SEC, but express provision for such abbreviated financial statements will likely increase efficiency and consistency**

Pro Forma Financial Information

Mandatory and Optional Adjustments

- **The old rules permitted limited adjustments in pro forma financial statements**
 - On **income statements**, the adjustments were limited to those that are directly attributable to the transaction, expected to have a continuing impact and factually supportable
 - On **balance sheets**, the adjustments were limited to those that were directly attributable to the transaction and factually supportable
- **These adjustments were not clearly defined, had the potential to result in inconsistent presentations even on comparable facts, and ignored the impact of expected integration efforts and other post-closing actions**

REVISED PRO FORMA ADJUSTMENTS		
Mandatory		Optional, <i>if conditions met</i>
Transaction Accounting Adjustments	Autonomous Entity Adjustments	Management's Adjustments
Reflect only the application of required accounting to the acquisition, disposition or other transaction linking the effects of the acquired company to the acquiror's historical financials	Represent adjustments necessary to reflect the operations and financial position of the acquiror as an autonomous entity when it was previously part of another entity	Represent adjustments (1) for forward-looking information that depicts the synergies and dis-synergies identified by management in determining to consummate the transaction or the integration of the acquired business and (2) that provide insight into the potential effects of the acquisition and the post-acquisition plans expected to be taken by management

- **The current standards used by auditors to provide customary negative assurance comfort on pro forma information are based on the old rules. As such, and particularly in the case of pro forma information including management's adjustments, early engagement with auditors will be important to ensure that adequate comfort is available to facilitate underwritten offerings**

Optional Management's Adjustments

- **The most controversial item in the SEC's proposed amendments was a mandatory requirement for management's adjustments. Various market participants (including Cravath) highlighted concerns that mandatory management's adjustments would force inherently uncertain / subjective assessments and would increase both the liability and burden associated with M&A disclosure**
- **In response, the revised rules instead provide that management's adjustments may be presented in the acquiror's discretion, if (1) management believes they would enhance understanding of the pro forma information and (2) various conditions related to basis and form are satisfied**
 - **Management's Adjustments—Basis**
 - Each adjustment must have a reasonable basis
 - The adjustments must be limited to the effect of synergies and dis-synergies as if they existed as of the beginning of the fiscal year presented
 - The pro forma information must reflect all adjustments that are, in management's opinion, necessary to a fair statement thereof. When synergies are presented, any related dis-synergies must also be presented
 - **Management's Adjustments—Form**
 - The adjustments must be presented in the explanatory notes to the pro formas and not on the face of the pro forma financial statements
 - Adjustments included in registration and proxy statements or 8-Ks must be as of the most recent practicable date prior to the effective date / qualified date / filing date, as applicable (which may necessitate updates to previously filed pro forma information incorporated by reference)
 - Any modifications to the number or potential number of common shares must be presented as if they existed as of the beginning of the fiscal year presented
 - Explanatory notes must include the basis and material limitations of each adjustment, including any material assumptions / uncertainties, an explanation of calculations (if material), and the estimated timing for achieving the synergies and dis-synergies
- **To address liability concerns, the revised rule provides that management's adjustments benefit from certain safe harbors for forward-looking statements in SEC filings**
 - The safe harbors cannot, however, fully mitigate the risk of litigation or adverse market reaction in response to unachieved synergies or unsatisfied expectations, and will require due diligence in the offering context

Other Topics

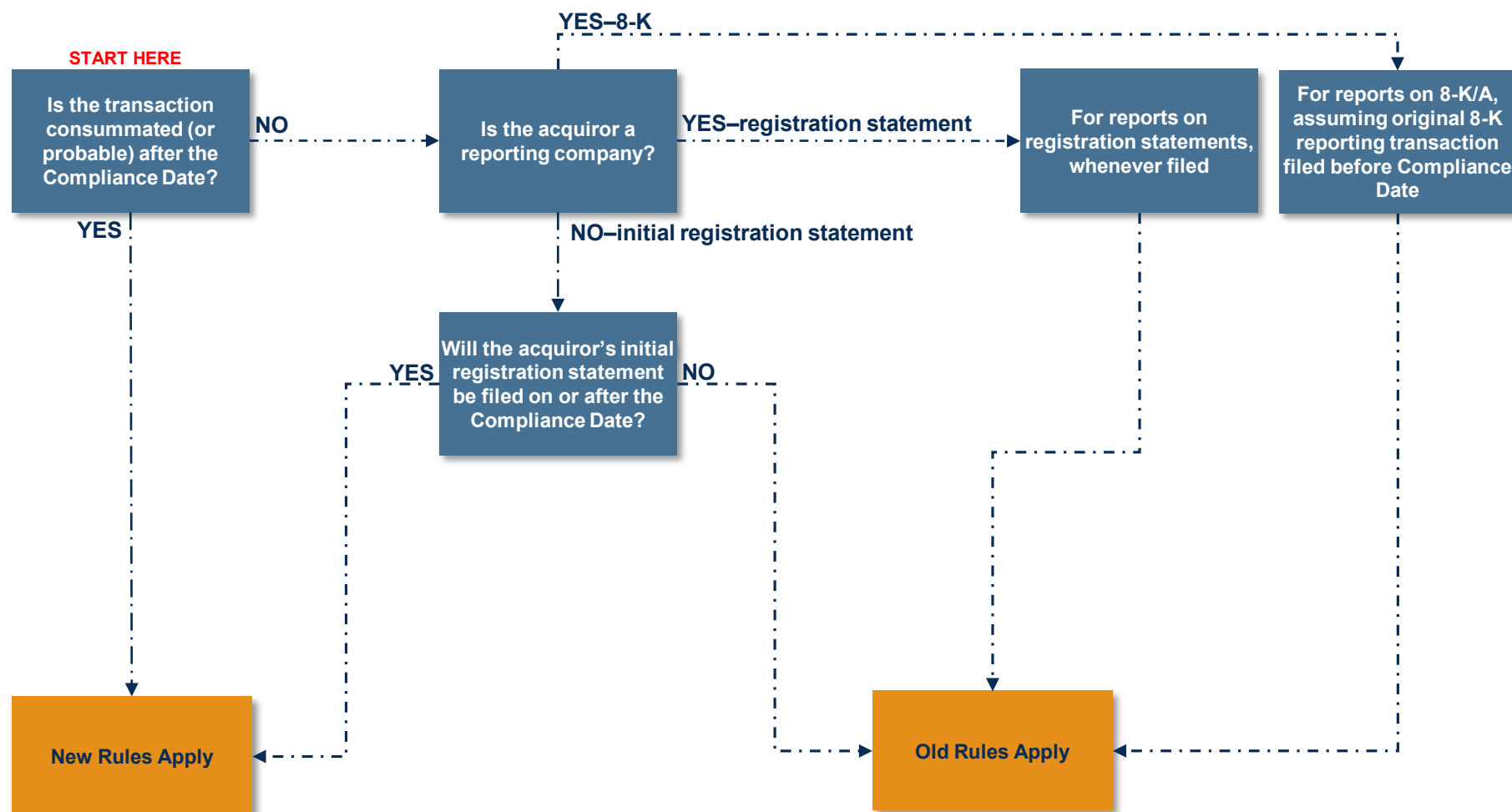
Financial Disclosure for Dispositions

- **Companies are required to file pro forma financial statements reflecting significant dispositions**
- **Under the old rules, the 8-K pro forma filing obligation was triggered by a disposition significant at the 10% level**
 - The deadline for filing the required pro forma financial statements is four¹ business days following the disposition
- **The amendments raise that significance threshold to 20% in order to conform to the corresponding threshold for acquisitions. The significance tests for dispositions have been conformed to those for acquisitions discussed above**

(1) While Form 8-K further allows a grace period of 71 calendar days to file by amendment acquired business financial statements, it does not make this grace period available in the case of dispositions

When Will the Amendments Take Effect?

- **An acquiror is required to evaluate a transaction under the new rules starting on the first day of its first fiscal year beginning after December 31, 2020 (the “Compliance Date”)**
 - The SEC permits voluntary compliance prior to the Compliance Date, provided that the new rules are thereafter applied in their entirety



Appendix: Foreign Acquired Businesses

The table below summarizes the accounting standard options available to acquirors when filing acquired business historical financial statements for acquired foreign companies that do not use US GAAP. The red boxed options are available as a result of the amendments

	Acquired Foreign Company Using IFRS-IASB	Acquired Foreign Company Using Home-Country GAAP
DOMESTIC ACQUIROR <i>(US GAAP)</i>	Qualifies as “Foreign Business” <ul style="list-style-type: none"> • No reconciliation or restatement needed 	Qualifies as “Foreign Business” < 30% significant <ul style="list-style-type: none"> • No reconciliation or restatement needed Qualifies as “Foreign Business” ≥ 30% significant <ul style="list-style-type: none"> • Restate using US GAAP; OR • Reconcile to US GAAP; OR • Restate using IFRS-IASB¹ Does not qualify as “Foreign Business” <ul style="list-style-type: none"> • Restate using US GAAP; OR • Reconcile to US GAAP; OR • If FPI definition satisfied, restate using IFRS-IASB¹
FPI ACQUIROR <i>(IFRS-IASB)</i>	Does not qualify as “Foreign Business” <ul style="list-style-type: none"> • Restate using US GAAP; OR • Reconcile to US GAAP; OR • If FPI definition satisfied, may use IFRS-IASB¹ 	Qualifies as “Foreign Business” < 30% significant <ul style="list-style-type: none"> • No reconciliation or restatement needed Qualifies as “Foreign Business” ≥ 30% significant <ul style="list-style-type: none"> • Restate using US GAAP; OR • Reconcile to US GAAP; OR • Restate using IFRS-IASB; OR • Reconcile to IFRS-IASB Does not qualify as a “Foreign Business” <ul style="list-style-type: none"> • Restate using US GAAP; OR • Reconcile to US GAAP; OR • If FPI definition satisfied, restate using IFRS-IASB; OR • If FPI definition satisfied, reconcile to IFRS-IASB

(1) If the acquiror presents its financial statements using US GAAP, reconciliation to US GAAP would still be needed to present pro forma financial statements.

CRAVATH

Worldwide Plaza

825 Eighth Avenue
New York, NY 10019-7475
212-474-1000 Phone
212-474-3700 Fax

CityPoint

One Ropemaker Street
London EC2Y 9HR England
+44-20-7453-1000 Phone
+44-20-7860-1150 Fax