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SEC Issues Final Rule to Improve Disclosures for Business Acquisitions and Dispositions

by Anish Alemao, Lisa Mitrovich, and Doug Rand, Deloitte & Touche LLP

Introduction

On May 20, 2020, the SEC issued a final rule[1] that amends the financial statement requirements for acquisitions and dispositions of businesses, including real estate operations, and related pro forma financial information. As noted in the final rule, the amendments "are intended to improve for investors the financial information about acquired or disposed businesses, facilitate more timely access to capital, and reduce the complexity and costs to prepare the disclosure." Among other changes, the final rule modifies the significance tests and improves the disclosure requirements for (1) acquired or to be acquired businesses, (2) real estate operations, and (3) pro forma financial information. In addition, the final rule includes amendments to financial disclosures specific to smaller reporting companies (SRCs)[2] and investment companies.[3] The final rule is applicable for a registrant's fiscal year beginning after December 31, 2020. However, early application is permitted.

[1] SEC Final Rule Release No. 33-10786, *Amendments to Financial Disclosures About Acquired and Disposed Businesses*.

[2] SRCs, as defined in SEC Regulation S-K, Item 10(f)(1), "General: Smaller Reporting Companies," and issuers relying on SEC Regulation A (collectively referred to as SRCs) should refer to the discussion in the Smaller Reporting Companies section for a summary of how the amendments may affect them.

[3] Investment companies registered under the Investment Company Act of 1940 and business development companies (collectively referred to as investment companies) should refer to the discussion in the Investment Companies section for a summary of how the amendments may affect them.

Background and Key Provisions of the Final Rule

SEC Regulation S-X, Rule 3-05,[4] currently requires registrants, including entities undertaking an initial public offering (IPO), to file the separate preacquisition financial statements for a significant acquired or to be acquired business (acquiree). Similarly, SEC Regulation S-X, Rule 3-14,[5] may require a registrant to provide preacquisition financial statements for a significant acquired or to be acquired real estate operation (real estate acquiree). The financial statement periods required to be filed are based on the significance levels determined by the registrant after performing the applicable significance tests in SEC Regulation S-X, Rule 1-02(w)[6] (i.e., the investment, asset, and income tests). Further, SEC Regulation S-X, Article 11,[7] requires a registrant to provide pro forma financial information depicting the impact of a significant acquisition or disposition. These disclosures can be important to investors because an acquisition or disposition may significantly affect a registrant's financial condition, results of operations, liquidity, and future prospects. In drafting the final rule, the SEC took into consideration constituents' feedback on its May 2019 proposed rule.[8]

"This action, which is designed to enhance the quality of information that investors receive while eliminating unnecessary costs and burdens, will benefit investors, registrants and the market more generally." — SEC Chairman Jay Clayton

Key amendments in the final rule will:

- Change the investment test to use the aggregate worldwide market value of common equity of the registrant when available.
- Change the income test to use the lower measure of significance based on (1) income from continuing operations before taxes or (2) revenue.
- Reduce the number of acquiree annual financial statement periods required to a maximum of the two most recent fiscal years.
- Require acquiree financial statements for an IPO in fewer circumstances.
- Modify the disclosure requirements for individually insignificant acquirees.
- Permit use of abbreviated financial statements for an acquiree in certain circumstances without a request for SEC staff permission.
- Extend the use of, and allow the reconciliation to, IFRS® Standards as issued by the International Accounting Standards Board (IASB®) (IFRS-IASB) in certain circumstances.
- Amend the pro forma financial information disclosures to require adjustments and certain disclosures for (1) "Transaction Accounting Adjustments" and (2) "Autonomous Entity Adjustments" when a registrant was previously part of another entity.
- Permit a registrant to present, in the explanatory notes to the pro forma financial information, "Management's Adjustments" (e.g., synergies or dis-synergies for which there is a reasonable basis), if certain conditions are met.
- Align certain requirements for a real estate acquiree with those in Rule 3-05.
- Raise the significance threshold for reporting dispositions of a business from 10 percent to 20 percent to conform the threshold with that of a significant acquisition.
- Make other changes specific to SRCs and investment companies.

Despite these changes, many elements of Rule 3-05 were retained under the amendments in the final rule. For example, although the amendments modify two of the significance tests, the final rule retains the use of bright line significance thresholds. In addition, the final rule retains the existing definition of a business for SEC reporting purposes. This definition, which is outlined in SEC Regulation S-X, Rule 11-01(d),[9] focuses on the continuity of operations, including revenue-producing activities, before and after the acquisition and is different from

[4] SEC Regulation S-X, Rule 3-05, "Financial Statements of Businesses Acquired or to Be Acquired."
[5] SEC Regulation S-X, Rule 3-14, "Special Instructions for Real Estate Operations to Be Acquired."
[6] SEC Regulation S-X, Rule 1-02(w), "Definitions of Terms Used in Regulation S-X: Significant Subsidiary."
[7] SEC Regulation S-X, Article 11, "Pro Forma Financial Information."
[8] SEC Proposed Rule Release No. 33-10635, *Amendments to Financial Disclosures About Acquired and Disposed Businesses*.
[9] SEC Regulation S-X, Rule 11-01, "Presentation Requirements."

the definition in ASC 805[10] or IFRS 3.[11] Further, some of the amendments codify existing SEC staff practice or interpretation and thus may not result in a significant change in practice.

Connecting the Dots

Although the amendments may reduce the financial statement requirements under Rule 3-05 (e.g., by eliminating a third year of acquiree financial statements), they do not extend to (1) target companies included in a proxy statement or registration statement on Form S-4 or (2) a company that is considered the predecessor[12] of a registrant.

Significant changes set forth in the final rule are discussed in further detail below. The Appendix includes a table summarizing the significant changes and a comparison of the disclosure requirements before and after adoption of the final rule.

Measuring Significance

As noted above, a registrant is currently required to perform the following three tests to determine the significance of an acquiree: the investment test, the asset test, and the income test. The test that results in the highest significance level is used to determine whether an acquisition is significant and the financial statement periods that must be presented. These tests are also used to evaluate significance in other circumstances, such as the disposition of a business (see the Disposition of a Business section). The final rule amends the investment and income test but does not modify the asset test.

Changes to the Investment Test for Business Acquisitions

Before adoption of the amendments, the investment test compared (1) the investment in the acquiree (generally the consideration transferred as measured in accordance with the applicable accounting standards)[13] with (2) the total assets of the registrant as of the end of the most recently completed fiscal year. This approach compared a fair value amount (i.e., consideration transferred) with an amount that often may reflect historical cost (i.e., total assets). The amendments modify the test to compare (1) the investment in the acquiree[14] with (2) the aggregate worldwide market value of the registrant's common equity. The aggregate worldwide market value is based on the average of the last five trading days of the registrant's most recently completed month-end before the earlier of (1) the registrant's announcement date or (2) the agreement date of the acquisition. If the registrant has no aggregate worldwide market value (e.g., when common equity is not publicly traded, including in an IPO), total assets should be used, in a manner consistent with the existing investment test.

Changes to the Income Test

Before adoption of the amendments, the income test consisted of a single component based on income from continuing operations before income taxes (pretax income), which often resulted in a high level of significance if a registrant had breakeven or near breakeven income or loss. Therefore, registrants may have been required to provide financial statements that were not material to investors. To reduce anomalous results that can occur under the income test, the amended income test consists of two components: the income component and the revenue component, both of which are based on financial information for the most recently completed fiscal year. A registrant must consider both components when evaluating significance and, only if it finds the results of both to be significant, uses the lower of the two

[10] FASB Accounting Standards Codification (ASC) Topic 805, *Business Combinations*.

[11] IFRS 3, *Business Combinations*.

[12] See paragraph 1170.1 of the SEC Division of Corporation Finance's Financial Reporting Manual (FRM).

[13] ASC 805 governs the measurement of consideration transferred unless the registrant is a foreign private issuer (FPI) that reports in accordance with IFRS-IASB, in which case IFRS 3 should be used.

[14] The amendments clarify that the investment in the acquiree must include (1) the fair value of contingent consideration if it must be recognized at fair value under the applicable accounting standards or (2) all contingent consideration (unless the likelihood of payment is remote) if recognition at fair value is not required under the applicable accounting standards.

components to determine the number of periods for which acquiree financial statements are required. Under the amended test:

- The income component is determined by comparing the absolute values of (1) the acquiree's pretax income or loss and (2) the registrant's pretax income or loss.
- If both the registrant and the acquiree have material revenue in each of the two most recently completed fiscal years, the revenue component is calculated by comparing the acquiree's revenue with the registrant's revenue.

The amendments also change the calculation of a registrant's average net income for the last five fiscal years, as contemplated in the computational notes to the existing Rule 1-02(w). The amendments require a registrant to use absolute values to calculate its average net income for the last five fiscal years, when applicable. This differs from the existing guidance in paragraph 2015.8 of the FRM, which indicates that "zero" should be used for any loss years in the computation of the average. While the revised calculation will increase the average income for those registrants that have reported losses during the last five fiscal years, the amendments also limit the use of income averaging to situations in which the revenue test is not applicable (i.e., either the registrant or the acquiree did not have material revenue in each of the two most recently completed fiscal years).

Connecting the Dots

The significance tests outlined in Rule 1-02(w) are used throughout the SEC's disclosure requirements and regulations, and the final rule retains the consistent application of the significance tests, with the exception of the investment test. Use of the aggregate worldwide market value in the investment test applies only when a registrant is evaluating business acquisitions and dispositions for significance. The final rule retains the existing test (i.e., use of total assets) in all other cases for which the investment test is required. Therefore, registrants will continue to apply the existing investment test when evaluating equity method investments for significance in accordance with SEC Regulation S-X, Rule 3-09,[15] or SEC Regulation S-X, Rule 4-08(g).[16] The amended income test described above, including the revenue component, however, will now apply when a registrant is evaluating equity method investments for significance in accordance with Rules 3-09 or 4-08(g).

In addition, in the context of the income test, the final rule does not provide specific thresholds for determining whether the registrant and acquiree had material revenue. We believe that registrants will need to exercise judgment when assessing, both quantitatively and qualitatively, whether the registrant and acquiree had material revenue.

Acquiree Financial Statements

The final rule allows, among other items, a registrant to (1) present fewer acquiree financial statement periods, (2) present acquiree financial statements in fewer circumstances, (3) use abbreviated financial statements without requesting SEC staff permission, and (4) use, or reconcile to, IFRS-IASB in certain circumstances:

[15] SEC Regulation S-X, Rule 3-09, "Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons."

[16] SEC Regulation S-X, Rule 4-08(g), "General Notes to Financial Statements: Summarized Financial Information of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons."

Fewer Acquiree Financial Statement Periods Required

- *Changes in annual periods presented* — Before adoption of the amendments, Rule 3-05 required registrants to present three[17] years of audited financial statements of the acquiree when the results of any of the three significance tests exceeded 50 percent. The amendments eliminate the requirement to file the third year of audited financial statements; therefore, the maximum number of financial statement periods required for an acquiree is two[18] years.
- *Changes in interim periods presented* — The amendments retain the requirement to provide interim financial statements but eliminate the requirement to provide the comparative prior-year interim period when only one year of audited acquiree financial statements are required (i.e., when any of the results of the significance tests are greater than 20 percent, but none are greater than 40 percent).

Connecting the Dots

While the SEC rules do not require interim periods of an acquiree to be reviewed by an independent auditor, a review is often performed at the request of management of the registrant. For the auditor to complete a review of the current interim period, the results of the prior-year comparable period may still need to be prepared.

Fewer Circumstances Requiring Acquiree Financial Statements

The amendments described above generally will result in fewer instances in which acquiree financial statements are required. In addition, the amendments include the following changes that will reduce the circumstances in which acquiree financial statements are required.

- *Changes to the requirement for acquiree financial statements in an IPO* — Under the amendments, acquiree financial statements are not required once the registrant's audited financial statements reflect the operating results of the acquiree for at least:
  - Nine months if any of the results of the significance tests are greater than 20 percent but none are greater than 40 percent.
  - A complete fiscal year if the results of any of the significance tests are greater than 40 percent.

  These changes may offer significant relief to companies undertaking an IPO since they may no longer be required to evaluate acquisitions that occurred before the most recently completed fiscal year.
- *Changes to the requirements for individually insignificant acquisitions*[19] — In circumstances in which the aggregate significance of individually insignificant acquisitions exceeds 50 percent, the amendments (1) remove the existing requirement to provide separate financial statements for a "substantial majority" of the acquirees and (2) require financial statements only for acquirees whose results on any significance test exceed 20 percent and for which separate financial statements are not yet required to be filed.[20] However, when the aggregate significance of individually insignificant acquisitions exceeds 50 percent, pro forma financial information must

[17] Before adoption of the amendments, (1) the third year of financial statements was not required if the acquiree reported less than $100 million in revenue during its most recent fiscal year and (2) when three years of financial statements were required, the balance sheet for the third year could be omitted.

[18] Before adoption of the amendments, emerging growth companies could omit the third year of any required acquiree financial statements during their IPO of common equity securities or for Form 8-K filings before the earlier of the filing or the filing deadline of their first Form 10-K. In addition, SRCs were not required to present more than two years of acquiree financial statements. Therefore, the amendments align the maximum number of acquiree financial statement periods to be presented for all registrants.

[19] Individually insignificant acquisitions include any acquisitions after the most recent audited annual balance sheet date that (1) were consummated and do not exceed 20 percent, (2) were consummated within 75 days of the date of the final prospectus or prospectus supplement for a registration statement or the date the proxy statement is mailed and exceed 20 percent but do not exceed 50 percent, and (3) are probable and do not exceed 50 percent.

[20] The amendments may accelerate reporting of historical financial statements for these acquirees in certain registration statements and proxy statements.

reflect the aggregate effects of all businesses acquired since the beginning of the fiscal year, even if preacquisition financial statements for such businesses are not required. In addition, the final rule now requires a registrant to include the aggregate impact of its real estate acquirees and its business acquirees to evaluate significance under the investment test. In a manner consistent with existing requirements, individually insignificant acquisition disclosures apply only to registration statements and proxy statements.

Connecting the Dots

Although the amendments eliminate the requirement to provide separate financial statements for individually insignificant acquirees, a registrant is still required to obtain sufficient historical financial information about all of its individually insignificant acquirees to prepare the required pro forma financial information when aggregate significance exceeds 50 percent, as described above. In addition, if material information is derived from financial records that have not been subject to audit or review, it may affect the level of comfort that auditors could provide to underwriters in conjunction with a securities offering.

Use of Abbreviated Financial Statements Without a Request for SEC Staff Permission

Historically, the SEC staff has permitted registrants, through waiver requests,[21] to present audited financial statements of assets acquired and liabilities assumed and statements of revenues and expenses (excluding corporate overhead, interest, and taxes), referred to as abbreviated financial statements, when certain criteria are met. The amendments permit registrants to present such abbreviated financial statements for an acquiree without seeking permission from the SEC staff when the following qualifying conditions are met:

- The assets and revenue of the acquiree represent 20 percent or less of the assets and revenue of the seller, as of and for the most recently completed fiscal year.
- The acquiree financial statements have not been previously prepared.
- The acquiree was not a separate entity, subsidiary, operating segment,[22] or division during the periods for which acquiree financial statements would be required.
- The seller did not maintain the "distinct and separate accounts" that would be necessary to present financial statements that include the omitted expenses, and the preparation of such financial statements is impracticable.

The qualifying conditions and presentation requirements for abbreviated financial statements in the amendments are generally consistent with the criteria that the SEC staff historically applied when evaluating a waiver request. When the qualifying conditions are not met, registrants may continue to request permission through a waiver request.

Use of, or Reconciliation to, IFRS-IASB in Certain Circumstances

SEC rules and regulations distinguish between a foreign acquiree[23] that meets the definition of a foreign business[24] and one that meets the definition of an FPI.[25] Before adoption of the amendments, only a foreign business acquiree was permitted to present IFRS-IASB financial statements without reconciliation. The amendments allow a registrant to present the financial statements of a foreign acquiree that does not meet the definition of a foreign business in

[21] Waiver requests are granted in accordance with the SEC staff's delegated authority under SEC Regulation S-X, Rule 3-13, "Filing of Other Financial Statements in Certain Cases."

[22] FASB Accounting Standards Codification Topic 280, *Segment Reporting*, defines operating segments. FPIs that report in accordance with IFRS-IASB should refer to IFRS 8, *Operating Segments*.

[23] A foreign acquiree, as used in the context of this publication, is an acquired or to be acquired business that is not incorporated in the United States.

[24] See paragraph 6110.4 of the FRM.

[25] See paragraph 6110.2 of the FRM.

accordance with IFRS-IASB without reconciliation to U.S. GAAP as long as the foreign acquiree would qualify to use IFRS-IASB if it were a registrant (i.e., if it would meet the FPI definition).

Connecting the Dots

Although the amendments increase the instances in which a registrant may provide financial statements of a foreign acquiree prepared in accordance with IFRS-IASB, without a reconciliation to U.S. GAAP, the pro forma financial information reflecting the acquiree must nonetheless be presented in accordance with the basis of presentation of the registrant. That is, a registrant that prepares its financial statements in accordance with U.S. GAAP and presents IFRS-IASB financial statements for a foreign acquiree must obtain sufficient historical financial information about the acquiree under U.S. GAAP to comply with the pro forma requirements of the registrant.

The amendments also allow FPIs that prepare their financial statements in accordance with IFRS-IASB to reconcile[26] home-country GAAP foreign acquiree financial statements to IFRS-IASB, rather than to U.S. GAAP as required under the existing requirements, if the foreign acquiree meets the definition of a foreign business or the foreign acquiree would meet the definition of an FPI if it were a registrant. The amendments also clarify the application of IFRS 1,[27] and certain SEC accommodations in a registrant's reconciliation of home-country GAAP to IFRS-IASB.

Pro Forma Financial Information

Pro forma financial information is generally required when separate financial statements are provided under Rule 3-05 or Rule 3-14 for a significant acquiree or real estate acquiree, respectively, or when there is a significant disposition of a business or real estate operation. The objective of pro forma financial information is to enable investors to understand and evaluate the impact of a transaction, such as the acquisition or disposition of a business, by showing how that transaction (or group of transactions) might have affected the registrant's historical financial position and results of operations had the transaction occurred at an earlier date.

Under the existing requirements in Article 11, pro forma financial information was generally presented in columnar form, with separate columns for the historical financial information, pro forma adjustments, and pro forma results. The historical financial statements were adjusted for amounts that were (1) directly attributable to the transaction, (2) factually supportable, and (3) with respect to the statement of comprehensive income, expected to have a continuing impact on the registrant. The amendments significantly change the requirements for preparing pro forma financial information by replacing the three criteria noted above with two categories of required adjustments and one optional disclosure, as follows:

- *Transaction accounting adjustments* — These adjustments are limited to adjustments that reflect the accounting for the transaction in accordance with U.S. GAAP or IFRS-IASB, as applicable. They may include, among other items, the recognition of goodwill and intangible assets and adjustments of assets and liabilities to fair value on the balance sheet, as well as the related impacts on the statement of comprehensive income, under the assumption that the balance sheet adjustments were made as of the beginning of the fiscal year presented. For dispositions, the adjustments may reflect the disposal of assets and related impacts.
- *Autonomous entity adjustments* — These adjustments, which are only required if the registrant was previously part of another entity, reflect incremental expense or other changes necessary to reflect the registrant's financial condition and results of operations as if it were a separate stand-alone entity. For example, if a public entity plans to distribute a portion of its business to its shareholders as a separate public

[26] Such reconciliation is generally required if the significance of the foreign acquiree exceeds 30 percent.
[27] IFRS 1, *First-Time Adoption of International Financial Reporting Standards*.

company (e.g., spin-off), its pro forma financial statements must include autonomous entity adjustments to reflect the incremental costs expected to be incurred as if it were a separate stand-alone entity. If the distributed entity's historical financial statements include allocated overhead costs of $5 million but it expects such costs to be $8 million as a stand-alone entity, a $3 million adjustment for additional overhead costs would be required, along with disclosures of the material assumptions and other qualitative information necessary for a fair and balanced presentation.

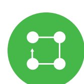
The amendments require registrants to provide separate columns in their pro forma financial information for (1) historical financial information, (2) transaction accounting adjustments, and (3) autonomous entity adjustments as well as a pro forma total, which would include pro forma earnings per share. In the notes to the pro forma financial information, a registrant must (1) clearly explain each adjustment and (2) detail any revenues, expenses, gains and losses, and related tax effects that will not recur in the registrant's statement of comprehensive income beyond a year from the transaction date.

Connecting the Dots

Before adoption of the amendments, adjustments to the pro forma statement of comprehensive income were expected to have a continuing (or recurring) impact on the registrant. The amendments do not distinguish between adjustments that are deemed recurring and adjustments that are deemed nonrecurring by management; however, they include a requirement to disclose items that will not recur in the explanatory notes to the pro forma financial information. For example, before adoption of the amendments, a registrant's pro forma statements of comprehensive income would include a pro forma adjustment to remove nonrecurring acquisition-related transaction costs. However, after adoption, such nonrecurring transaction costs must remain in the pro forma statements of comprehensive income, with a disclosure in the explanatory notes that such transaction costs are not expected to recur.

Disclosure of Management's Adjustments

In addition to the required adjustments noted above, the amendments give registrants the flexibility to present, in the explanatory notes to the pro forma financial information, management's adjustments, which reflect synergies and dis-synergies identified by management when evaluating whether to consummate an acquisition. Management's adjustments also may provide insight on the potential effects of the acquisition and the plans that management expects to take after the acquisition (which may include forward-looking information).[28] Such adjustments, to the extent they do not qualify as a transaction accounting or autonomous entity adjustment, may include, among other things, closing facilities, discontinuing product lines, and terminating employees. When synergies are presented, any related dis-synergies must also be presented.



Connecting the Dots

While the final rule does not define synergies or dis-synergies, we believe that these terms generally refer to the benefits (i.e., increased revenue or decreased expenses) and costs (i.e., decreased revenue or increased expenses), respectively, that may result from a transaction. The final rule requires registrants to consider both, which ensures a balanced presentation.

To enable investors to separate the accounting impact of the transaction from the impact of management's plans after the transaction, the amendments require management's adjustments to only "be presented in the explanatory notes . . . in the form of reconciliations of pro forma net income . . . and the related pro forma earnings per share data to such

[28] The amendments also revise Article 11 so that any forward-looking information supplied is expressly covered by the safe harbors under Securities Act Rule 175 and Exchange Act Rule 3b-6.

amounts after giving effect to Management's Adjustments." If pro forma amounts reflecting management's adjustments are disclosed elsewhere in a filing (e.g., management's discussion and analysis), pro forma amounts *excluding* management's adjustments must also be presented with equal or greater prominence along with a reference to the reconciliation provided in the explanatory notes.

To present management's adjustments, a registrant must meet the following new conditions to ensure that such adjustments are presented consistently and in a manner that would enhance an understanding of the transaction:

- *Basis of management's adjustments* — Management's adjustments may only be presented in the explanatory notes to the pro forma financial information if (1) there is a reasonable basis for each adjustment, (2) the adjustments are limited to the effect of the synergies and dis-synergies for the periods presented, (3) reductions in an expense do not exceed the related expense reflected in the pro forma period presented, and (4) all such adjustments that, in the opinion of management, are necessary for a fair statement of the pro forma financial information are reflected (and a statement to that effect is provided).
- *Form of presentation of management's adjustments* — In addition to the requirement to present management's adjustments in the form of a reconciliation in the explanatory notes, the amendments also require certain disclosures to aid investors in evaluating management's adjustments, including "the basis for and material limitations of each Management's Adjustment, including any material assumptions or uncertainties of such adjustment, an explanation of the method of the calculation of the adjustment, if material, and the estimated time frame for achieving the synergies and dis-synergies."[29] These adjustments must reflect the most current assumptions available as of the effective date of a registration statement or filing date, which may require changes to previously issued pro forma financial information when it is provided in later filings.

Connecting the Dots

While the final rule introduces many new concepts for pro forma financial information, the requirements for disclosure of pro forma amounts that reflect management's adjustments are consistent with a few of the primary requirements for non-GAAP measures.[30] For example, management's adjustments must be presented in a "reconciliation" format, and when such measures are presented outside pro forma financial information, pro forma amounts excluding management's adjustments must also be presented with "equal or greater prominence."

Real Estate Operations

Companies in the real estate industry apply Rule 3-14 to report the acquisition or probable acquisition of a real estate operation (real estate acquiree). The final rule includes a number of changes to substantially align Rule 3-14 with Rule 3-05 in an effort to reduce complexity while retaining certain industry-specific disclosures where appropriate. In addition, the final rule includes several other changes to Rule 3-14, many of which codify positions that the SEC staff has historically applied and that were standard industry practice (and therefore are not discussed below). Among other changes, the final rule:

- Increases the significance threshold from 10 percent to 20 percent for an individual real estate acquiree and disposed real estate operation.
- Increases the significance threshold from 10 percent to 50 percent for the aggregate impact of certain consummated and probable real estate acquisitions for which financial statements are (1) not required or (2) not yet required (individually

[29] SEC Regulation S-X, Rule 11-02(a)(7)(ii)(D).
[30] See SEC Regulation S-K Item 10(e), "Use of Non-GAAP Financial Measures in Commission Filings."

insignificant real estate acquirees) and aligns the disclosure requirements with those in Rule 3-05 as described in the Changes to the requirements for individually insignificant acquisitions discussion above. For example, under the amendments, a registrant is not required to provide separate financial statements for any individually insignificant real estate acquiree; however, pro forma financial information should reflect the aggregate effects of all such real estate acquirees. In addition, the final rule now requires a registrant to consider the related requirements in Rule 3-05 if it has both real estate acquirees and business acquirees. In this case, the registrant would need to include the aggregate impact of its business acquirees and its real estate acquirees to evaluate significance under the investment test. In a manner consistent with existing requirements, these changes apply only to registration statements and proxy statements.

- Reduces the three-year annual financial statement requirement for significant real estate acquirees from related parties to one year and no longer differentiates the number of periods on the basis of whether the seller is a related party.
- No longer requires financial statements of a real estate acquiree in registration statements and proxy statements once the real estate acquiree has been reflected in the registrant's financial statements for nine months (see the Changes to the requirement for acquiree financial statements in an IPO discussion for a summary of the analogous provision in Rule 3-05).
- Permits the filing of financial statements covering a period of 9 to 12 months to satisfy the one-year requirement for a real estate acquiree, in a manner consistent with Rule 3-05.
- Specifies that the investment test[31] for assessing the significance of a real estate acquiree is consistent with the evaluation of business acquisitions in accordance with Rule 3-05 in that it compares the registrant's investment in the real estate operation (excluding any debt secured by the real properties that is assumed by the registrant) to the registrant's aggregate worldwide market value unless such value is not available. In that case, in a manner consistent with current practice, the investment test compares the registrant's investment in the real estate operation, including any debt secured by the real properties that is assumed by the registrant, with the registrant's total assets as of the most recently completed fiscal year.

Connecting the Dots

Because many real estate companies rely on mortgages and other debt to finance their investments, total assets may exceed their aggregate worldwide market value. Notwithstanding other changes described herein, for companies with an aggregate worldwide market value, the change to the investment test may result in higher levels of significance. Registrants may consider a waiver request when they believe the investment test would result in the filing of real estate acquiree financial statements that would not be material to investors. For companies for which an aggregate worldwide market value is not available (e.g., nontraded real estate investment trusts), there is no change to the substance of the investment test for real estate acquirees as currently applied.

- Conforms the requirements related to acquisitions of foreign real estate operations in Rule 3-14 with the analogous provisions in Rule 3-05 (see the Use of, or Reconciliation to, IFRS-IASB in Certain Circumstances section).
- Does not differentiate between a real estate acquiree with a triple-net lease and one without. Therefore, the final rule clarifies that a registrant must provide financial

[31] While a registrant that acquires real estate operations applies only the investment test to measure significance, a registrant considers all three significance tests outlined in Rule 1-02(w) when evaluating whether a disposition of real estate operations is significant.

statements of a real estate acquiree in accordance with Rule 3-14 rather than provide the financial statements of the lessee or guarantor of the lease, which is the existing practice.[32]

- Codifies existing SEC staff practice for blind pool offerings, which is to calculate the significance of a real estate acquiree as set forth in paragraphs 2325.3 and 2325.5 of the FRM. In a manner consistent with current industry practice, the final rule also extends this guidance to business acquisitions under Rule 3-05 that are carried out during a blind pool offering.

Disposition of a Business

Before adoption of the amendments, Article 11 required pro forma financial information for the disposition or probable disposition of a business when it exceeded the 10 percent significance level on the basis of any of the three significance tests noted above. The amendments raise the significance threshold from 10 percent to 20 percent and align the investment and income test with the revised tests for a business acquisition. Therefore, for the investment test, a registrant must compare the fair value of consideration received (including contingent consideration) with the aggregate worldwide market value of the registrant (or, if there is no market value, compare the carrying value of the disposed business with the total assets of the registrant). This differs from the existing investment test, as interpreted in paragraph 2130.2 of the FRM, which compared the greater of (1) the carrying value of the disposed business or (2) the fair value of consideration received with the registrant's total assets. Similarly, under the amendments, the registrant must consider both the income component and the revenue component of the income test and compare pretax income and revenue of the disposed business with those of the registrant.

Connecting the Dots

Although the amendments modify the investment test and increase the significance threshold for the disposal of a business to 20 percent, they do not modify such requirements for the acquisition or disposition of a significant[33] amount of assets that do not constitute a business in accordance with Article 11. Form 8-K, Item 2.01, continues to require disclosure, including pro forma financial information, for asset acquisitions and dispositions for which significance exceeds 10 percent.

Smaller Reporting Companies

The final rule includes corresponding changes to the requirements for SRCs. Before adoption of the amendments, SEC Regulation S-X, Article 8,[34] required financial statements and pro forma financial information for acquirees; however, it did not provide the same level of detailed guidance as Rule 3-05 and Article 11. After adopting the amendments, SRCs may continue to prepare acquiree financial statements in accordance with Article 8 (e.g., the form and content requirements); however, SRCs must refer to the requirements in Rules 3-05 and 3-14 for other requirements. Similar changes were made for pro forma financial information, and thus SRCs must refer to Article 11 for the presentation and disclosure of such information (except for the condensed format allowed for SRCs).

Investment Companies

Before adoption of the amendments, investment companies followed the same general requirements of Rule 3-05 and Article 11 as other registrants. However, because of the unique characteristics of investment companies, it was often unclear how to apply these rules.

[32] See Section 2340 of the FRM for existing guidance regarding properties subject to triple-net leases.

[33] Form 8-K, Item 2.01, *Completion of Acquisition or Disposition of Assets*, states the acquisition or disposition of assets that do not constitute a business in accordance with Article 11 is significant "*if the registrant's . . . net book value of such assets or the amount paid or received for the assets upon such acquisition or disposition exceeded 10% of the total assets of the registrant*" (italics added).

[34] SEC Regulation S-X, Article 8, "Financial Statements of Smaller Reporting Companies."

The amendments add SEC Regulation S-X, Rule 6-11,[35] and Rule 1-02(w)(2), which, among other things, provide investment-company–specific significance tests: (1) the investment test, which focuses on the value of the total investments, and (2) the income test, which uses measures commonly included in the investment company's financial statements, such as changes in net assets from operations.[36] In addition, the amendments (1) make certain revisions to the significance thresholds that may reduce the need to provide financial statements and (2) limit the number of audited financial statement periods required for an acquired fund to one year and the most recent interim period. Further, the amendments allow the use of U.S. GAAP financial statements for an acquired private fund supplemented by schedules that comply with SEC Regulation S-X, Article 12[37] (including a detailed schedule of investments), rather than financial statements that comply with the provisions of Regulation S-X. The amendments also replace the existing requirement for pro forma financial information for a fund acquisition with a requirement to provide certain supplemental information about fees and investments.

Effective Date and Transition

The final rule will become effective at the beginning of the registrant's fiscal year that starts after December 31, 2020 (e.g., the mandatory compliance date would be January 1, 2021, for calendar-year-end companies). However, voluntary compliance is permitted before the effective date as long as the final rule is applied in its entirety on that date.

Registrants that (1) are subject to the reporting requirements of Section 13(a) or 15(d) of the Exchange Act on the mandatory compliance date and (2) file registration statements on or after the mandatory compliance date may test acquisitions and dispositions that occurred before the mandatory compliance date in accordance with the rules that were applicable at the time the acquisitions or dispositions were consummated. Further, registrants that initially report an acquisition or disposition under Item 2.01 of Form 8-K before their mandatory (or voluntary) compliance date must comply with the rules that were in effect when the initial Form 8-K was filed (or required to be filed), even if the financial statements and pro forma information will be filed by amendment to the initial Form 8-K after the mandatory (or voluntary) compliance date.

Example

- Registrant A acquires Company B on May 11, 2020.
- Company B is 55 percent significant to A under the rules in effect when the initial Form 8-K is filed. Therefore, A must provide B's audited financial statements covering three years and any required interim periods.
- Registrant A files its initial Form 8-K announcing the acquisition on May 15, 2020 (i.e., within four business days). Registrant A has an additional 71 calendar days before it will be required to file B's financial statements and pro forma financial information in a Form 8-K/A.
- Registrant A elects May 30, 2020, as its voluntary compliance date for the final rule.
- After adopting the amendments in the final rule, B is 41 percent significant to A.

Registrant A must file an amendment to its initial Form 8-K and provide (1) B's audited financial statements covering **three** years, (2) B's required interim periods, and (3) related pro forma financial information prepared under the prior guidance within 71 calendar days of May 15, 2020 (i.e., within 71 calendar days of the initial Form 8-K filing). Even though the amended Form 8-K must be filed after the voluntary compliance date, since the initial Form 8-K was filed before the voluntary compliance date, Registrant A must comply with the requirements in effect when the initial Form 8-K was filed (i.e., the requirements in effect before the adoption of the amendments in the final rule). If A believes the third year of financial statements of B are not material for investors, it may consider requesting a waiver from the SEC.

[35] SEC Regulation S-X, Rule 6-11, "Financial Statements of Funds Acquired or to Be Acquired."
[36] The final rule refers to including, for example, "any net realized gains and losses and net change in unrealized gains and losses."
[37] SEC Regulation S-X, Article 12, "Form and Content of Schedules."

For companies filing an IPO, the final rule is effective for initial registration statements first filed on or after the mandatory compliance date, including assessment of probable and consummated acquisitions and dispositions, even those consummated before the mandatory compliance date. Similarly, voluntary compliance is permitted before the effective date as long as the final rule is applied in its entirety.

Registrants are encouraged to reach out to SEC staff for additional transition guidance in connection with early compliance with the rules.

Looking Ahead

This final rule represents a substantial simplification of the disclosure requirements for business acquisitions and dispositions and highlights the SEC's continued focus on improving disclosure effectiveness and encouraging capital formation. Recently, the SEC finalized amendments to simplify disclosures related to guarantors and collateralizations of securities, which are discussed in Deloitte's March 10, 2020, *Heads Up*. Both of these rules address considerations outlined in the SEC's September 2015 request for comment on the effectiveness of financial disclosures about entities other than the registrant. In addition to these topics, the request for comment[38] also addressed disclosures for equity method investments. While the amendments to the significance tests described above will also modify the income test for equity method investments, no further changes have been proposed to date.

[38] SEC Release No. 33-9929, *Request for Comment on the Effectiveness of Financial Disclosures About Entities Other Than the Registrant*.

Appendix — Summary of Key Changes

The following is a summary of the key changes in the final rule that have an impact on the disclosures of an acquisition or disposition of a business in accordance with Rule 3-05 and Rule 11-01; therefore, the summary does not address acquisitions of real estate operations or acquisitions by business development companies, investment companies, or SRCs. The table should be read in conjunction with this *Heads Up*.

	Before Amendments	Final Rule
Significance Tests		
Investment test for business acquisitions	The investment test compares (1) the investment in the acquiree with (2) the **total assets** of the registrant.	The investment test compares (1) the investment in the acquiree with (2) the **aggregate worldwide market value of the registrant's common equity**. If there is no aggregate worldwide market value of the registrant's common equity, the test uses the registrant's total assets.
Income test	The income test consists of a **single component** based on financial information for the most recent fiscal year: • *Income component* — Compares the absolute values of the acquiree's pretax income or loss with the registrant's pretax income or loss.	The income test consists of **two components** based on financial information for the most recent fiscal year: • *Income component* — Compares the absolute values of the acquiree's pretax income or loss with the registrant's pretax income or loss. • *Revenue component* — Compares the acquiree's **revenues** with the registrant's revenues. A registrant must consider both components when evaluating significance, and only if it finds the results of both to be significant, uses the lower of the two components to determine the number of periods for which acquiree financial statements must be presented. The revenue component does not apply if either the registrant or acquiree did not have material revenue for the two most recently completed fiscal years.
	In the calculation of a registrant's average net income for the last five fiscal years, "zero" must be used for any loss years in the computation of the average.	In the calculation of a registrant's average net income for the last five fiscal years, **absolute values** must be used in the computation of the average. However, income averaging would only be available for the income component of the income test if the registrant is not able to apply the revenue component.
Acquiree Financial Statements		
Periods required — annual	On the basis of the highest level of significance, registrants must provide audited annual financial statements for the following number of years: • *Significance exceeds 50 percent* — **Three years**. • *Significance exceeds 40 percent but not 50 percent* — **Two years**. • *Significance exceeds 20 percent but not 40 percent* — **One year**.	On the basis of the highest level of significance, registrants must provide audited annual financial statements for the following number of years: • *Significance exceeds 40 percent* — **Two years**. • *Significance exceeds 20 percent but not 40 percent* — **One year**.

(Table continued)

	Before Amendments	Final Rule
Acquiree Financial Statements (continued)		
Periods required — interim	Unaudited interim financial statements for the most recent interim period and the **comparative prior-year interim period** are required for all levels of significance.	On the basis of the highest level of significance, registrants provide the following unaudited interim financial statements: • *Significance exceeds 40 percent* — The most recent interim period and the **comparative prior-year interim period**. • *Significance exceeds 20 percent but not 40 percent* — The most recent interim period **(the comparative prior-year interim period is not required)**.
Registration statements for IPOs	Registrants must evaluate significance for **all** acquirees during (1) the **latest three fiscal years** (or the **latest two fiscal years** for emerging growth companies and SRCs) and (2) any subsequent interim period through the date the initial registration statement is declared effective. Audited financial statements are required for the number of years indicated by the significance tests. Preacquisition, postacquisition, or a combination of preacquisition and postacquisition audited results may satisfy the financial statement requirement.	Registrants must evaluate significance for **all** acquirees during (1) the **latest fiscal year** and (2) any subsequent interim period through the date the initial registration statement is declared effective. Audited preacquisition financial statements are required for the number of years indicated by the significance tests unless the registrant's audited financial statements reflect the operating results of the acquiree for: • Nine months if any of the results of the significance tests are greater than 20 percent but none are greater than 40 percent. • A complete fiscal year if the results of any of the significance tests are greater than 40 percent.
Individually insignificant acquisitions	When filing a registration or proxy statement and the aggregate significance of all individually insignificant acquisitions exceed 50 percent, a registrant must provide: • Financial statements for the **substantial majority** of individually insignificant acquisitions. • Pro forma financial information to reflect the aggregate effects of the **substantial majority** of individually insignificant acquisitions.	When filing a registration or proxy statement and the aggregate significance of all individually insignificant acquisitions exceed 50 percent, a registrant must provide: • Financial statements only for acquirees that **exceed 20 percent significance** and have not yet been filed. • Pro forma financial information to reflect the aggregate effects of **all individually insignificant** acquisitions.
Abbreviated financial statements	A registrant must seek SEC staff permission to use abbreviated financial statements if it acquires net assets that constitute a business.	A registrant may use abbreviated financial statements **without requesting** SEC staff permission if it acquires net assets that constitute a business that (1) represent 20 percent or less of the seller's revenue and assets and (2) meet certain other criteria.
Use of IFRS-IASB financial statements, without reconciliation to U.S. GAAP	A registrant is permitted to present IFRS-IASB financial statements, without reconciliation to U.S. GAAP, if it acquires a significant foreign acquiree that meets the definition of a foreign business.	A registrant is permitted to present IFRS-IASB financial statements, without reconciliation to U.S. GAAP, if it acquires a significant foreign acquiree that meets the definition of a foreign business or would meet the definition of an **FPI if it were a registrant**.

(Table continued)

	Before Amendments	Final Rule
Acquiree Financial Statements (continued)		
Reconciliation requirements for acquiree home-country GAAP financial statements	FPIs that prepare their financial statements in accordance with IFRS-IASB must reconcile home-country GAAP financial statements of a foreign acquiree to **U.S. GAAP** even when the foreign acquiree meets the definition of a foreign business or would meet the definition of an FPI if it were a registrant.	FPIs that prepare their financial statements in accordance with IFRS-IASB may reconcile home-country GAAP financial statements of a foreign acquiree to **IFRS-IASB** if the foreign acquiree meets the definition of a **foreign business** or would meet the definition of an **FPI if it were a registrant**.
Pro Forma Financial Information		
Pro forma adjustments	Adjustments must be: • Directly attributable to the transaction. • Factually supportable. • For the statement of comprehensive income, expected to have a continuing impact.	*Transaction accounting adjustments* — These adjustments must reflect the transaction in accordance with U.S. GAAP or IFRS-IASB, as applicable. *Autonomous entity adjustments* — If the registrant was previously part of another entity, these adjustments must reflect the registrant's financial condition and results of operations as if it were a separate stand-alone entity. *Management's adjustments (optional)* — These adjustments may reflect synergies and dis-synergies of acquisitions and dispositions when certain criteria are met.
Presentation	Separate columns are presented for the: • Registrant. • Acquiree. • Pro forma adjustments. • Pro forma total.	Separate columns are presented for the: • Registrant. • Acquiree. • **Transaction accounting adjustments**. • **Autonomous entity adjustments**. • Pro forma total. Management's adjustments, if presented, may not be reflected on the face of the pro forma financial statements but should be included in the explanatory notes in the form of a reconciliation.
Business Dispositions		
Form 8-K filing requirements	A registrant must file a Form 8-K when a disposed business **exceeds 10 percent significance**.	A registrant must file a Form 8-K when a disposed business **exceeds 20 percent significance**.

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