

# Seriously Entertaining Compliance

## Grant Thornton's SEC reporting podcast

### Episode 1: Significant acquisitions

#### Speakers

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#### Transcript

**Cindy Williams:** Welcome to Grant Thornton's SEC reporting podcast, "Seriously Entertaining Compliance," making SEC reporting a little less stressful one episode at a time, where we discuss a variety of SEC reporting topics, including available staff guidance and interpretations. In this episode, we are going to dive into the popular topic of determining significance of an acquired or to be acquired business under Regulation S-X. While this podcast will not cover all aspects of the significance test, we hope to provide you with enough information to educate you on this topic so that you can be on your way to determine if an acquisition is significant or not. I am your host, Cindy Williams, and I work in Grant Thornton's national office focusing on SEC regulatory and reporting matters, and I have Tom Eldredge.

Welcome, Tom. Would you like to introduce yourself?

**Tom Eldredge:** Yeah. Hi, Cindy, and thank you for having me on the podcast today. Welcome, everyone. I'm Tom Eldredge. I'm a partner in Grant Thornton's national office as a national professional practice director in our West region. Very happy to be with you today.

**Cindy Williams:** Awesome. All right, so let's get started. The applicable rules and regulations to look at when determining whether a recent or probable acquisition is deemed significant include S-X rules 1-02(w), 3-05, 8-04, and 11-01.

So before we dive into the significance test, the first step is to determine whether the acquisition qualifies to be a business under SEC reporting rules. Tom, can you tell us a little bit more about the SEC definition of a business?

**Tom Eldredge:** Of course. So the first thing to note is that the definition of a business under the SEC reporting rules is different from GAAP definitions. So an acquisition that's accounted for as an asset acquisition under GAAP may still be an acquisition of a business under SEC reporting rules. The definition of a business is included in S-X Rule 11-01(d), and focuses on the continuity of the acquiree's operations before and after the acquisition so the disclosure of pre-acquisition financial statements is material to an understanding of future operations.

An acquired entity is presumed to be a business if it was a separate entity, subsidiary or division of the seller. In addition, a lesser component of an entity may also meet the definition of a business. The company should work with their SEC counsel to determine whether the acquisition constitutes an acquisition of a business under the SEC reporting rules. For accounting purposes, the definition of a business is included in ASC 805. Once again, it's important to remember, however, that the definitions are different between SEC rules and GAAP, so an acquiree could qualify to be a business under one set of rules but not the other.

**Cindy Williams:** Thanks all great points. So what if the acquired entity does not have any revenues or customer base? Would that entity be considered an acquired business?

**Tom Eldredge:** Good question. So Corp Fin staff has indicated that generating revenue is not a requirement to be a business as defined in Regulation S-X. As an example, biotech or tech companies with little or no revenue may constitute a business under SEC reporting rules. So look out for those startups.

**Cindy Williams:** Thank you, Tom. An important first step when evaluating an acquisition for sure.

So now that we are clear on the definition of a business under Regulation S-X, we can move on to determining significance of such acquisition. There are three tests that are prescribed in S-X Rule 102(w), the asset test, the income test and the investment test. If the acquired business meets the significant threshold of any of these tests, certain pre-acquisition financial statements are required to be presented pursuant to Rule 3-05 or Rule 805 for smaller reporting companies. Certain pro forma financial information is also required pursuant to S-X Article 11. Keep in mind that the financial statement and

pro forma requirements for acquired businesses come into play for both existing SEC registrants and companies planning to go public.

So Tom, assuming the acquisition meets the definition of a business, can you walk us through how to calculate the individual significant test?

**Tom Eldredge:** Sure. The financial statements used in these tests are usually those for the most recently completed fiscal year for the registrant and the acquired business. For the purpose of the significant test calculations, it doesn't matter if the acquiree's fiscal year end is different to the registrants. The most recently completed fiscal year for each entity is used. There are certain exceptions to this, such as in a reverse acquisition or reverse recapitalization or situations where the registrant has acquired other significant businesses after its most recently completed fiscal year.

We're not going to be talking about these today. However, guidance for such situations is included in FRM Section 2915. Moving on to the significance tests, as noted earlier, there are three significance tests to consider whether there's acquired businesses considered significant. The asset test is probably the simplest of the three tests. You take the registrant's proportionate share of the acquired business' consolidated assets over the registrant's consolidated total assets. Intercompany transactions are eliminated for the purposes of this test. In several instances, the registrant may not acquire cash balances or other working capital amounts.

Nonetheless, such amounts shall continue to be included in the numerator because, if you think about it, the working capital is expected to be required and funded after acquisition.

**Cindy Williams:** So the numerator is the proportionate share of the registrar and its subsidiaries. Does that mean if the registrar acquires 80% interest in the acquiree, the numerator will be 80% of the total assets of the acquiree?

**Tom Eldredge:** Yeah, that's absolutely right. Moving on to the investment test, you take the registrant's investment in and advances to the tested business over the registrant's aggregate worldwide market value of its voting and non-voting common equity securities.

Now investments in, in the context of investment test, means consideration transfer, which ordinarily is the GAAP purchase price. The aggregate worldwide market value used in the denominator is the average of the registrant's voting and non-voting common equity calculated daily for 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. So for example, let's say the registrant entered into a sale and purchase agreement in May, files a Form 8K within four business days to announce the transaction, and the transaction closes in June. Well, in this fact pattern, the aggregate worldwide market value is calculated based on the last five trading days in April.

The register doesn't have aggregate worldwide market value, which is often the case in an IPO situation. Total assets of the most recently completed fiscal year are used in the denominator.

**Cindy Williams:** Just to clarify for the listeners, the aggregate worldwide market value is different than public float. The aggregate worldwide market value includes the value of equity held by affiliates, while public float excludes equity held by affiliates. Another thing to note is that in situations where the company has more than one class of equity securities, the aggregate worldwide market value is computed using only the class that is traded on a public market.

Common stock that is not traded on a public market but is exchangeable for share of common stock that is traded on a public market is excluded from the denominator. Also, preferred shares that are convertible into a class of common equity that is traded on a public market are also excluded.

**Tom Eldredge:** Yeah, great. Great point and thank you for that, Cindy. So lastly let's get into the income test, which has two components. First is the income component which takes the absolute value of the registrant's equity in the acquired business' consolidated pre-tax income or loss from continuing operations attributable to controlling interests over the absolute value of such income or loss of the register.

The second component is the revenue test, which takes the registrants proportionate share of the acquired business' consolidated total revenue from continuing operations over such total revenue of the registrant. So similar to the asset test, the numerator is the proportionate interest of the registrant and its subsidiaries. So if the registrant is acquiring only 80% of the acquiree, the numerator is going to be 80% of the pre-tax income or revenue. Now the revenue component, moving away from income to revenue now, only applies if both the registrant and the acquired business have material revenues during the most recent two fiscal years. This determination is made separately for the registrant and then separately for the inquiry and it's done in the context of that

business' specific facts and circumstances and not as compared with that of the registrant.

If the revenue component does not apply, meaning there's not material revenues during each of the two most recently completed fiscal years for the register or the acquiree, then the registrant has an option. That option is under S-X Rule 1-02(w) to use the average income for the last five fiscal years as the denominator in the income test, only if, however, the absolute value of the registrant's income or loss from continuing operations before taxes, that is pre-tax income, for the most recent fiscal year is 10% or more lower than the average of the absolute value of such amounts in that five-year period.

Now, intercompany transactions are also eliminated in computing the amounts for the income test. For the income test, remember that both the income component and the revenue component need to exceed 20% in order for the acquired business to be considered significant when evaluating the income test.

**Cindy Williams:** Wow, that was a lot. But thank you for simplifying the three tests for all of us. When significance exceeds 20% but not 40%, one year of audited financial statements and unaudited subsequent interim financial statements are required under Rule 3-05 of S-X. Prior-period comparatives would not be required.

But when significance exceeds 40%, two years of audited financial statements and unaudited subsequent interim statements are required and such financial statements cannot use Private Company Council (or PCC) alternatives and the annual financial statements are required to be audited in accordance with either AICPA or PCAOB standards. Certain pro forma financial information is also required pursuant to S-X Article 11. If a company wishes to pre-clear its conclusions relating to whether an acquisition constitutes a business as defined in S-X Rule 11-1-01, or if they believe the results of significance tests are anomalous and want to request relief from providing such financial statements, the company can submit a pre-clearance or relief request with Corp Fin's OCA, and the link for that is on the slide.

Well, that wraps up this SEC reporting podcast. Thank you for joining us. And now that we have covered how to calculate significance and what is required if an acquisition is significant, tune into our next podcast where we will go into more detail of the requirements such as financial statements and pro forma information. Again, I'm Cindy Williams.

Tom Eldredge: And I'm Tom Eldredge.

Tom Eldredge and Cindy Williams: Until, next time.

Cindy Williams: Thank you.