CFOs and the acquisition process

Key considerations SEC registrants should be aware of before closing the next M&A transaction

As an integral stakeholder in strategy planning for mergers and acquisitions (M&A), chief financial officers (CFOs) provide vital financial leadership and alignment of business and finance strategy. For many companies, M&A transactions are an infrequent and often substantial undertaking with many potentially significant consequences. Included among them are important accounting and financial reporting issues and opportunities. As with any other major business decision, the homework your company does prior to the acquisition can influence the outcome. The following are key areas of financial reporting to consider before undertaking the acquisition process.

Information to be gathered up front
Typically, an acquired business (hereafter, acquiree) will need to provide certain financial information to the acquiring company as part of the due diligence process. If either party to the acquisition process is a US Securities and Exchange Commission (SEC) registrant, incremental information may be needed. Determining the SEC reporting and public company acquisition disclosure requirements for a transaction often requires judgment and evaluation of the areas below, among others.
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The definition of a business
The definition of a business for SEC reporting purposes is not the same as the definition under US Generally Accepted Accounting Principles (US GAAP). The SEC definition focuses primarily on whether the nature of the revenue-producing activity generally remains the same after the acquisition. The definition of a business under US GAAP—Financial Accounting Standards Board's (FASB's) Business Combinations (Topic 805)—focuses first on whether a screen test is met where the acquisition is determined to be a single asset acquisition and, if not met, on whether inputs, processes, and outputs have been acquired.

Judgment is often required to determine whether an acquiree meets the definition of a business according to SEC rules, especially when a company acquires a portion of a business, such as an operating segment or a product line. A company may consider seeking concurrence from the SEC staff before the acquisition closes.

Significance of the acquired business
The size of the acquiree (which the SEC refers to as “significance”) will determine what financial information, if any, must be included in SEC filings. Three tests (the asset test, the investment test, and the income test) must be performed to determine the significance of the acquiree. The test that results in the highest significance level will determine the financial statement periods of the acquiree that will be needed, generally as follows:

- **Not more than 20 percent**—No financial statements required
- **More than 20 percent but not more than 40 percent**—Financial statements for the most recent fiscal year (audited), the latest year-to-date interim period that precedes the acquisition date (unaudited), and the corresponding interim period of the prior year (unaudited)
- **More than 40 percent but not more than 50 percent**—Financial statements for the two most recent fiscal years (audited), the latest year-to-date interim period that precedes the acquisition date (unaudited), and the corresponding interim period of the prior year (unaudited)
- **More than 50 percent**—Financial statements for the three most recent fiscal years (audited), the latest year-to-date interim period that precedes the acquisition date (unaudited), and the corresponding interim period of the prior year (unaudited)

Your company will want to understand if the acquiree can make available audited annual and unaudited interim financial statements as part of negotiations in the acquisition process because the preparation and subsequent audit of financial statements can require a significant amount of time and resources.

Pro forma financial information
A pro forma balance sheet and income statement are generally required under SEC rules if the business acquisition is deemed to be significant:

- **Balance sheet**—based on the registrant’s latest balance sheet included in the filing. Adjustments should be computed assuming the transaction was consummated on the balance sheet date. They should be directly attributable to the specific transaction and factually supportable.
- **Income statement**—based on the registrant’s latest fiscal year and interim period included in the filing. Adjustments should be computed assuming the transaction occurred at the beginning of the fiscal year presented and was carried forward through any interim period presented. Adjustments should give effect to events that are directly attributable to each specific transaction, be factually supportable, and be expected to have a continuing impact.

Term sheet or purchase agreement
Once the financial statement requirements are identified, your company can include a provision in the term sheet or purchase agreement to require the acquiree to provide the financial information as a condition precedent for the transaction so the information is available when or if needed. Your company should also consider specifying that such financial information would need to be audited, which party is able to choose the audit firm, and which party will incur the costs for the financial statement preparation, audit, and interim reviews (if necessary).
When information is required

As with so many other business considerations, timing is everything when it comes to SEC reporting and public company acquisition disclosure requirements. Here are four key scenarios to consider:

Current report on Form 8-K requirements
An SEC registrant must file an initial Form 8-K within four business days of the consummation of a significant business acquisition. The registrant then has an additional 71 calendar days to file an amended Form 8-K that contains the financial statements required, including pro forma financial information.

Financing the acquisition
An SEC registrant may sometimes complete an offering of securities prior to the consummation of the business acquisition to raise the necessary capital. In doing this, the acquiree’s financial statements and related pro forma financial information may need to be provided before the acquisition is consummated.

Proxy statement requirements
The acquiree’s financial statements and related pro forma financial information may be required in proxy statements, depending on which organization’s shareholders must approve the transaction and the nature of the consideration—i.e., cash only, cash and equity, or equity only. Additional disclosures for the acquiree (e.g., management’s discussion and analysis) may also be required.

Updating requirements for future registration statements
An SEC registrant may be required to update the acquiree’s financial statements and related pro forma financial information in future registration statements.
Other important considerations
Once the deal closes, other reporting requirements and internal control considerations come into play. It’s important to consider these up front and make preparations so the associated deadlines don’t catch your company by surprise:

Internal control over financial reporting
During the year of the acquisition, an SEC registrant may exclude the internal control over financial reporting of an acquired business from its annual assessment of internal control over financial reporting under requirements of the Sarbanes-Oxley Act of 2002. However, after this initial transition period, the registrant will need to consider the acquired entity in its evaluation of internal control.

Purchase accounting considerations
Under US GAAP, business combinations require the allocation of the purchase price to the assets acquired and the liabilities assumed based on fair value. Fair value specialists may be needed to assist in determining the allocation of the purchase price.

Annual and quarterly disclosure requirements
Under US GAAP, business combination disclosures can be lengthy and complex, including, among others, pro forma revenue and earnings and fair value disclosures as well as the purchase price allocation.

Changing lanes
In May 2019, the SEC issued a proposed rule that would amend the financial statement requirements for acquisitions and dispositions of businesses as well as related pro forma financial information. The proposal is intended to improve the information investors receive regarding acquired or disposed businesses, reduce complexity and costs of preparing the required disclosures, and facilitate timely access to capital. These changes could be significant for many companies, so it’s important to monitor developments in this area.

See Deloitte’s May 9, 2019 Heads Up for more information about the proposed rule.
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Let’s talk
If your company is considering making an acquisition or being acquired in the coming year, early consideration of and action regarding the issues described above may help smooth the acquisition process.

Deloitte is a leading adviser in the M&A space. Through a range of accounting and reporting advisory services, we assist our clients to achieve their transaction’s potential while helping them identify potential ways to minimize risk during the acquisition process.

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Endnotes

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