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Practice Pointers on Financial Statement Requirements for Significant Acquisitions and Pro Forma Financial Information

Introduction

A company's acquisition of another business often results in significant changes to its results of operations and future prospects, which may influence the investment decisions of potential investors. When a company that files periodic reports with the Securities and Exchange Commission (SEC) makes a "significant" acquisition of a business, the company may need to file financial statements of the acquired business or target.[1] In such a case, the requirements for financial statements may become complex, and may even apply before completion of the acquisition (when the acquisition becomes "probable"). Further, the term "business" may refer to an entire company, a portion or subdivision of an entity, or a group of businesses.

These practice pointers discuss the extent to which the financial statements of an acquired business must be included in an acquirer's Form 8-K, registration statement, or proxy statement, as well as the related requirements with respect to pro forma financial information. The significance of an acquisition is measured by any of three tests comparing aspects of the acquired business to the acquirer, as described below. These tests measure significance as a percentage. Generally, the more significant the acquisition, the more financial data that must be presented. Of course, SEC requirements set forth the minimum disclosure required, and deal teams and counsel should consider whether it would be prudent to, or market practice might suggest that the company should, include additional financial information in SEC filings or include comparable financial information in offerings or transactions that are exempt from SEC registration.

Overview of Rule 3-05

The main requirements[2] regarding the inclusion of the financial statements of an acquired business in SEC filings are set forth in Rule 3-05 ("Rule 3-05") of Regulation S-X ("Reg S-X")[3] under the Securities Act of 1933, as amended (the "Securities Act"). In general, a company must file the relevant financial statements within 75 days of a significant acquisition. Financial information may also need to be provided in registration statements (including post-effective amendments) and some proxy statements depending on factors such as the significance of the acquisition, its timing, and its materiality to investors.

Financial Statements of the Business Being Acquired

Definition of a Business

The significance analysis begins with determining the scope of the business that is being acquired. The SEC sets forth a facts-and-circumstances test and does not limit the definition of a business to the usual notion of a stand-alone or well-defined company. For instance, "a separate entity, a subsidiary, or a division"[4] is presumed to be a business, but less substantial components may also constitute a business for purposes of this analysis. Major considerations include whether the component will continue to generate revenue in generally the same manner as prior to the acquisition and whether specific attributes will remain with the component.[5] The SEC's definition of a business under Reg S-X is also not the same as the definition under U.S. Generally Accepted Accounting Principles (GAAP).

The SEC may also treat a group of related businesses as a single business for purposes of this analysis and for purposes of presenting combined financial statements. In determining whether a group of related businesses should be combined, the SEC focuses on whether (1) the businesses are under common control or management, (2) the acquisition of one business is conditioned on the acquisition of each other business, or (3) each acquisition is conditioned upon the occurrence of a single common event.[6] For such combined businesses, one combined set of financial statements for any time periods during which the businesses are under common control or management would suffice.

On January 5, 2017, the Financial Accounting Standards Board (FASB) issued an Accounting Standards Update (ASU 2017-1) clarifying the definition of a business.[7] Under the current implementation guidance in Topic 805 (Business Combinations), a business has three elements: inputs, processes, and outputs. While a business usually has outputs, outputs are not required to be present to qualify as a business. In addition, not all of the inputs and processes are required to qualify as a business, but only if market participants can replace the missing elements, for example through integration with its existing operations. According to feedback previously received by the FASB, application of the current guidance is commonly thought to be too

[1] References to "acquired business" and "target" in these practice pointers are used interchangeably.
[2] These requirements are referred to by the instructions to various SEC forms, such as Form 8-K, Forms S-1, S-3, F-1, and F-3 for registration statements, and Schedule 14A for proxy statements.
[3] Unless otherwise specified, all rules referenced herein are under Reg S-X.
[4] *See* Rule 11-01(d).
[5] These attributes include, among others: (1) physical facilities, (2) employee base, (3) market distribution system, (4) sales force, (5) customer base, (6) operating rights, (7) production techniques, and (8) trade names. *See id.*
[6] *See* Rule 3-05(a)(1)(3).
[7] *See* FASB Accounting Standards Update No. 2017-1, Business Combinations (Topic 805): Clarifying the Definition of a Business (January 2017).

complex and costly, resulting in too many transactions qualifying as business combinations. Under the ASU, when substantially all of the fair value of gross assets acquired is concentrated in a single identifiable asset (or a group of similar identifiable assets), the assets acquired do not represent a business, thus eliminating the need for further assessment. In addition, to be considered a business, an acquisition must include, at a minimum, an input and a substantive process that together contribute to the ability to create outputs.[8] For public companies, the ASU is effective for annual periods beginning after December 15, 2017, including interim periods within those periods. For all other companies, the ASU is effective for annual periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019.

Significance and Significance Tests

After identifying the business being acquired, a company must evaluate the significance to the acquirer of the business. Rule 3-05 refers to the three significance tests derived from the definition of "significant subsidiary" under Rule 1-02(w). However, the financial statement filing requirements become applicable at a higher bottom threshold (20% significance) than the 10% significance level under Rule 1-02(w). No single test is more or less important than the others. Instead, the significance level for an acquired business is the highest level calculated by any one of the three tests. These tests include:

- The *investment test*, which compares the amount of the acquirer's investment in the acquired business to the acquirer's total assets;
- The *total asset test*, which compares the acquirer's share of the acquired business's total assets to the acquirer's consolidated total assets; and
- The *pre-tax income test*, which compares the acquirer's equity in the acquired business's income from continuing operations before income taxes, extraordinary items, and cumulative effect of a change in accounting principles compared to the income of the acquirer.

For each test, the acquirer's and the target's most recent annual audited financial statements are used, although there are several exceptions, as discussed below. Several threshold significance levels trigger various financial statement filing requirements (for registration statements that have not yet been declared effective):

- *Below 20% significance level*: If the acquired business does not exceed 20% of any of the three significance criteria, there is no requirement to include audited or interim financial statements;
- *20% significance level*: If the acquired business exceeds 20% of any of the three significance criteria, audited financial statements for the most recent fiscal year of the acquired business must be included and for the latest required unaudited interim period that precedes the acquisition and the corresponding unaudited interim period of the preceding year;[9]
- *40% significance level*: If the acquired business exceeds 40% of any of the three criteria, audited financial statements for the two most recent fiscal years of the acquired business must be included and for the latest required unaudited interim period that precedes the acquisition and the corresponding unaudited interim period of the preceding year; and
- *50% significance level*: If the acquired business exceeds 50% (or if securities are being registered for sale to the holders of securities of the acquired business), audited financial statements for the three most recent fiscal years of the acquired business must be included and for the latest required unaudited interim period that precedes the acquisition and the corresponding unaudited interim period of the preceding year.[10] Financial information is also required when individually insignificant business acquisitions aggregate to over 50% since the date of the acquirer's latest audited year-end balance sheet filed with the SEC.[11]

[8] The ASU provides a framework to evaluate when an input and substantive process is present (including for early stage companies that have not generated outputs), and no longer requires an assessment if a market participant could replace any missing elements. The ASU also narrows the definition of outputs so that the term is consistent with how outputs are described in Topic 606 (Revenue from Contracts with Customers). Under the new definition, an output is the result of inputs and processes that provide goods or services to customers, other revenue, or investment income, such as dividends and interest.

[9] An exception is available under Rule 3-05(b)(3), which applies if the acquirer has completed a significant acquisition after its latest fiscal year-end and filed a report on Form 8-K including audited financial statements for the acquired business and the pro forma financial information required by Article 11 (discussed below). In such a case, the significance comparisons may be based on the pro forma financial information rather than the historical financial information of the acquirer. An acquisition that may exceed the 20% significance level based on historical information might not exceed the 20% significance level based on the pro forma financial information, and thus would not trigger the requirements discussed above.

[10] However, an exception is available for an acquired business that had revenues below $50 million in its most recent fiscal year, in which case the audited financial statements for the earliest of the three fiscal years may be omitted.

[11] If the company has acquired multiple businesses that individually do not exceed the 20% significance level, but in the aggregate exceed the 50% significance level, then the company must file financial statements for at least the substantial majority of these individually insignificant businesses. Financial statements for the latest required unaudited interim period that precedes the acquisition and the corresponding unaudited interim period of the preceding year will also be required, if applicable.

In addition, for all significance levels exceeding 20%, unaudited interim financial statements may also be required depending on the time of year that the acquisition takes place or becomes "probable." The target's financial statements must also satisfy the usual staleness deadlines.

Notwithstanding the above, no financial statements need to be filed if the acquired business does not exceed the 50% significance level and either (1) the acquisition has not yet been consummated or (2) the date of the final prospectus (or mailing date of the proxy statement) is no more than 74 days after the acquisition and the financial statements of the acquired business have not yet been filed.[12] For very significant acquisitions (greater than 50% significance level), a company must provide financial statements in a registration statement (including a post-effective amendment) and some proxy statements even if the acquisition is probable but not yet consummated. In such a situation, takedowns under a previously effective shelf registration statement are also suspended until the appropriate financial statements have been filed, as is discussed in more detail below. Whether an acquisition is "probable" is determined on a case-by-case basis and depends on the particular facts and circumstances. Such highly significant transactions can also result in the suspension of takedowns under any existing shelf registration statement until the financial statements have been filed, as discussed in more detail below. In addition, the financial statements of the acquired business must be included if the acquisition was 75 days or more before the date of the final prospectus or mailing date of the proxy statement. Finally, if the financial statements have been previously filed (such as under Form 8-K), the exemption is no longer available.

Requirements Under Form 8-K

Item 2.01 of Form 8-K requires disclosure of the acquisition by a company (or any of its majority-owned subsidiaries) of "a significant amount of assets, otherwise than in the ordinary course of business." Item 9.01(a)(4) of Form 8-K effectively requires the eventual filing of the financial statements of an acquired business within 75 days of the acquisition. The 75-day deadline has two components. First, the Form 8-K providing notice of the acquisition itself must be filed within four *business* days of the acquisition event. Then, according to Item 9.01(a) of Form 8-K, the necessary financial information can be filed with this initial Form 8-K or, alternatively, by amendment within 71 *calendar* days of the due date of the initial Form 8-K.

Item 9.01 of Form 8-K clarifies that companies should file financial statements of the acquired business for the periods specified in Rule 3-05(b), as described above. Additionally, for all transactions contemplated under Item 2.01 of Form 8-K, the company must provide any pro forma financial information that Article 11 of Reg S-X would require.

The Instruction to Item 9.01 of Form 8-K imposes additional restrictions for a recent or probable acquisition. Until the required financial statements are filed, the company will be considered current in its reporting obligations under the Securities Exchange Act of 1934, as amended (the "Exchange Act").

Requirements for Registration Statements

Registration statements (including post-effective amendments) will not be declared effective until the necessary financial statements (meeting the requirements of Rule 3-05) are filed. Generally, such financial statements are necessary for any acquisition that was completed 75 days or more before the filing or date of effectiveness of such registration statement or amendment. The financial information may be included within the registration statement itself or incorporated by reference to a previously filed Form 8-K.

There is generally no need to include financial statements for a recent or probable acquisition that is below the 50% significance level unless such information was previously filed.[13] In other words, if an issuer voluntarily filed a Form 8-K with the necessary financial statements before the end of the 75-day grace period allowed by that form, then the issuer must provide the financial statements with any registration statement (including any post-effective amendment) following that filing. This can be accomplished by incorporating by reference the Form 8-K into the registration statement. Companies should keep in mind that even if a recent or probable acquisition is below the 50% significance level, the acquisition may still rise to a level of materiality warranting disclosure in the registration statement.

Acquirers of multiple businesses also should be cautious of individually insignificant acquisitions that may, in the aggregate, reach the 50% significance level. As discussed in more detail below, such an aggregation of acquisitions requires that financial information be provided for the substantial majority thereof in order to satisfy Rule 3-05.

In December 2015, the SEC staff issued guidance on whether an EGC can omit financial statements of other entities from its filing or submission if it reasonably believes that those financial statements will not be required at the time of the offering.[14] Under Section 71003 of the Fixing America's Surface Transportation Act (the "FAST Act"), an EGC could omit financial statements of an acquired business required by Rule 3-05 of Regulation S-X if the EGC reasonably believes those financial statements will not be required at the time of the offering. This situation could occur when an EGC updates its registration

[12] *See* Rule 3-05(b)(4).
[13] *See* Rule 3-05(b)(4)(i).
[14] *See* Compliance and Disclosure Interpretations - *Fixing America's Surface Transportation (FAST) Act* (last updated Aug. 17, 2017), Question 2; see also *Financial Reporting Manual*, Section 2030.4.

statement to include its 2017 annual financial statements prior to the offering and, after that update, the acquired business has been part of the EGC's financial statements for a sufficient amount of time to obviate the need for separate financial statements.

Special Requirements for Public M&A Transactions

An acquirer's use of Form S-4 or Form F-4 to register securities to be offered to owners of a target triggers different requirements. Rule 3-05(b)(1) specifies the required financial statements in this situation. Major factors influencing the exact disclosure requirements include whether the business being acquired is a Securities Act registrant and whether the acquirer's shareholders must vote on the offer. For instance, if (1) the securities being offered to the target's security owners will be registered on Form S-4, (2) the target is not a reporting company under the Exchange Act, and (3) the target's shareholders are not voting, then (A) no financial statements are required if the recent or probable acquisition is below the 20% significance level and (B) GAAP financial statements for only the most recent fiscal year and interim period are required if the recent or probable acquisition is above the 20% significance level. However, if the target provided GAAP financial statements for either of the two years before the most recent fiscal year, those would be required as well.

Special Requirements for Shelf Takedowns

Takedowns under an existing, effective shelf registration statement might also be impacted by acquisitions. This is an important consideration because issuers set up shelf registration statements for purposes of quickly accessing the capital markets. Offerings under an effective shelf registration statement must be suspended if there has been an acquisition exceeding the 50% significance level (or if such a transaction is probable) until the required financial statements have been filed.[15] For less significant transactions, there is generally no specific obligation to update the prospectus in the existing registration statement if (1) the acquisition has not been consummated or (2) the final prospectus supplement for the takedown is dated within 74 days after the consummation of the acquisition and the acquired company financial statements have not already been filed. Such financial statements, however, could still be provided in order to market the offering to investors depending on the materiality of the acquisition. If offerings under an effective shelf registration statement are suspended, a company could still conduct an offering exempt from registration, as discussed in more detail below.

However, Instruction to Item 9.01 of Form 8-K states that, until the filing has been completed for such a significant acquisition, a company should not conduct offerings under Rule 504 or 506 of Regulation D ("Regulation D") under the Securities Act if any purchaser is not an accredited investor under Rule 501(a) of Regulation D, with a few exceptions.[16] During this blackout period, a company could still conduct unregistered offerings under Section 4(a)(2) of the Securities Act ("Section 4(a)(2)"), Rule 144A under the Securities Act ("Rule 144A"), or (if all purchasers are accredited investors) Rule 504 or 506 of Regulation D. As a result, companies that are conducting registered offerings and Regulation D offerings simultaneously with acquisitions must coordinate the timing of such offerings with the filing of the required financial statements.

Notwithstanding the above, a "fundamental change" may also require an amendment to the prospectus in the existing shelf registration statement, as stipulated by Section 10(a)(3) of the Securities Act and the "undertakings" requirements of Item 512(a) of Regulation S-K under the Securities Act.[17] Therefore, an acquirer should consider whether a completed (or probable) acquisition that is significant under Rule 3-05 would comprise a fundamental change and thus require an amendment to the shelf registration statement. As discussed above, individually insignificant acquisitions also can be aggregated to constitute a fundamental change, and this possibility must be considered. Further, individually insignificant acquisitions occurring after the most recent audited balance sheet but before the effectiveness of the shelf registration statement may be combined with acquisitions occurring after effectiveness for purposes of aggregation.

Requirements for Proxy Statements (Under Schedule 14A)

In general, proxy statements must include sufficient information for shareholders to make an informed vote with respect to an upcoming shareholders' meeting. When action will be taken to authorize, issue, exchange, or modify securities, financial statements should be included if such financial statements would be material to a voting decision.[18] Financial statements may be material to a voting decision if the action involves the authorization or issuance of a material amount of senior

[15] This exception is not available to blank check companies.

[16] The exceptions include (1) offerings or sales of securities upon the conversion of outstanding convertible securities or upon the exercise of outstanding warrants or rights, (2) dividend or interest reinvestment plans, (3) employee benefit plans, (4) transactions involving secondary offerings, and (5) sales of securities pursuant to Rule 144 under the Securities Act. *See also* Securities and Exchange Commission, *Financial Reporting Manual*, Section 2050.3 [*Financial Reporting Manual*], which advises companies not to make offerings under Rule 504 or 506 of Regulation D before the required audited financial statements are filed.

[17] *See Financial Reporting Manual*, Section 2045.3. For a non-shelf registration statement, Item 11(b)(ii) of Form S-3 specifically requires retroactive revision of the pre-event audited financial statements that were incorporated by reference to reflect a subsequent change in accounting principle (or consistent with SEC staff practice, discontinued operations and changes in segment presentation) if the Form S-3 also incorporates by reference post-event interim financial statements. *See Financial Reporting Manual*, Section 13110.2. The SEC has not provided a formal definition of "fundamental change."

[18] *See Financial Reporting Manual*, Section 1140.2.

securities or securities related to a business combination. In a proxy statement for a business combination, important considerations include which entity's shareholder votes are being solicited and the form of consideration, as is outlined in the table below.[19] If the securities are being registered on Form S-4 or F-4 to be offered to the target's owners, special requirements may apply, as described above.[20]

<table>
<tr><th>Solicited Shareholders</th><th>Consideration</th><th>Financial Statements</th></tr>
<tr><td>Acquirer Only</td><td>Cash only</td><td rowspan="2">• Financial statements of the target are required.
• Financial statements of the acquirer are not required unless they are material to an informed voting decision.
• Pro forma financial information is required if it is material to a voting decision.</td></tr>
<tr><td>Acquirer Only</td><td>Exempt securities only or a combination of exempt securities and cash</td></tr>
<tr><td>Target Only</td><td>Cash only</td><td>• Financial statements of the target are not required unless it is a going private transaction.
• Financial statements of the acquirer are not required unless they are material to an informed voting decision.
• No pro forma information is required.</td></tr>
<tr><td>Target Only</td><td>Exempt securities only or a combination of exempt securities and cash</td><td>• Financial statements of the target are not required unless it is a going private or a roll-up transaction.
• Financial statements of the acquirer are generally required.
• Pro forma financial information is required, if material.</td></tr>
<tr><td>Acquirer and Target</td><td>Cash only</td><td>• Financial statements of the target are required.
• Financial statements of the acquirer are not required unless they are material to an informed voting decision.
• Pro forma financial information is required if it is material to a voting decision.</td></tr>
<tr><td>Acquirer and Target</td><td>Exempt securities only or a combination of exempt securities and cash</td><td>• Financial statements of the target are required.
• Financial statements of the acquirer are generally required.
• Pro forma financial information is required, if material.</td></tr>
</table>

Exempt Offerings

Even if a company has not yet complied with the requirements of Reg S-X in order to have a registration statement declared effective or use an existing shelf registration statement, the company can sell securities in an offering or transaction that is exempt from registration. In this case, the requirements of Rule 3-05 would not be applicable. As mentioned above, companies should be aware that market practice may still be to provide acquired business financial information. In some cases, underwriters or investors may insist upon such financial disclosures as part of the information necessary to properly evaluate the investment. For example, the financial information included in offering documents for unregistered offerings (for example, Rule 144A offerings) is often very similar to the financial information included in registration statements. However, since such information need not comply with the requirements of Rule 3-05, companies have more flexibility as to the scope and presentation of the acquired business financial information.

A company also has a variety of options in structuring an exempt offering, such as a PIPE transaction or a Rule 144 offering. A PIPE transaction typically involves a private placement of securities to accredited investors under Rule 506 of Regulation

[19] For more information, *see* the table available in *Financial Reporting Manual*, Section 1140.3.
[20] *See Financial Reporting Manual*, Section 1140.4.

D, with trailing resale registration rights often provided to investors. In such cases, the company agrees to file a resale registration statement, after the closing of the transaction, covering the restricted securities in order to enable investors to freely transfer the securities. A PIPE transaction thus allows the company to sell securities before the necessary financial information has been filed, if investors are willing to wait a certain period of time before a resale registration statement is available. In a Rule 144A offering, an investment bank, acting as an initial purchaser, acquires the securities in a private placement under Section 4(a)(2) and then resells the securities to qualified institutional buyers (QIBs) pursuant to Rule 144A. The securities issued in a Rule 144A transaction are restricted, like securities issued in a PIPE transaction, but there is an active secondary market for Rule 144A securities that provides some measure of liquidity for investors.

As mentioned above, in connection with exempt offerings, a company may provide to investors for marketing purposes certain material non-public financial information (which might not comply with the requirements under Rule 3-05 and which may include pro forma financial information) pursuant to non-disclosure agreements (NDAs). These NDAs also restrict investors from trading on such financial information until such financial information becomes publicly available or a certain period of time has elapsed, whichever occurs earlier. A company and the financial intermediary might consider sharing with potential investors pro forma financial information that is preliminary or the target's financial statements even if these are not yet ready to be filed in order to enable investors to form a view on the acquisition and the combined company. In this case, the company and the financial intermediary might also seek to obtain "big boy" letters from institutional investors under which these investors acknowledge, among other things, that they have had an opportunity to review preliminary financial information about the target and/or combined financial information and ask questions of, and receive answers from, the company, concerning such information, have undertaken an independent analysis of the merits and risks of an investment in the securities, have not received or relied on any communication, investment advice or recommendation from the financial intermediary, etc., but have not been furnished with complete financial information. In the case of a PIPE transaction, after sharing such financial information pursuant to NDAs, the company would prepare and file financial information compliant with Rule 3-05 before filing the resale registration statement in order to ensure no delay in the effectiveness of the resale registration statement.

Another advantage of structuring an exempt offering as a PIPE transaction relates to the closing deliverables, which are typically less extensive in comparison to registered offerings and Rule 144A offerings. For example, in a PIPE transaction, only issuer's counsel typically provides a legal opinion, which often does not include negative assurance language, and a comfort letter is not usually provided. Although a Rule 144A offering does not involve a registration statement, and thus there is no potential liability under Sections 11 and 12 of the Securities Act, the closing deliverables for a Rule 144A offering (e.g., comfort letter, officers' certificate, and legal opinions) are very similar to the closing deliverables for registered offerings because the initial purchaser in a Rule 144A offering still purchases the securities as principal before reselling the securities to QIBs. As a result, the initial purchaser in a Rule 144A offering has underwriter liability, in which case the comfort letter and legal opinions help provide the initial purchaser with a "due diligence" defense. This also explains why the offering documents in Rule 144A offerings also contain more extensive disclosures than the offering documents in PIPE transactions. In a PIPE transaction, the securities are "placed" with investors by a placement agent prior to the filing of a resale registration statement, in which case the placement agent does not have underwriter liability because the placement agent is not purchasing the securities as principal. As a result, placement agents in PIPE transactions often do not require comfort letters and negative assurance letters for a "due diligence" defense. Further, if a comfort letter cannot be provided in a traditional Rule 144A offering, the financial intermediary instead might act as a placement agent (rather than an initial purchaser), in which case the offering would be structured as a Section 4(a)(2) private placement of securities to investors that qualify as QIBs (sometimes referred to as a "Rule 144A qualifying transaction") and a comfort letter would not be required.[21] Therefore, if there are timing or other logistical issues with obtaining a comfort letter, a PIPE transaction or a Rule 144A qualifying transaction may be an alternative to a traditional Rule 144 offering.

When an Acquisition Becomes "Probable"

As mentioned above, the most significant acquisitions require disclosure of financial statements even when they are probable rather than concluded. However, acquisitions that are probable and would exceed the 50% significance level may trigger financial statement disclosure requirements for registration statements or proxy statements.[22]

The term "probable" is not expressly defined, and SEC guidance indicates that the determination of whether a transaction is "probable" depends upon the facts and circumstances.[23] A major consideration is whether the company's financial statements alone would not provide adequate financial information to make an informed investment decision.[24] In addition, other factors may imply that an acquisition is probable. These factors include, but are not limited to: (1) a definitive

[21] A Rule 144A qualifying transaction clears and settles through The Depository Trust Company (DTC) with a Rule 144A CUSIP number.
[22] A filing also might be required by Item 1.01 of Form 8-K if the probable acquisition is based on a material definitive agreement.
[23] *See* Securities Act Release No. 33-6413 (July 9, 1982).
[24] *See Financial Reporting Manual*, Section 2005.4 [referring to Codification of Financial Reporting Policies, Section 506.02(c)(ii)].

agreement with the target business;[25] (2) a letter of intent; (3) shareholder or board of director approval; (4) submission of transaction terms for review by regulatory agencies; (5) the existence of financial penalties for non-consummation; or (6) a public announcement. However, the context remains important. For example, if several acquirers are competing over or bidding for a target business, consummation of the acquisition is not necessarily probable for any particular potential acquirer.

Industry Roll-Ups

There is special guidance for industry roll-ups, where discrete businesses are aggregated into a larger business which then undergoes an initial public offering (IPO).[26] The SEC's view is that such aggregations were not contemplated in the drafting of Rule 3-05. Therefore, significance is measured against the company's size at the time of its registration statement filing rather than at the time of each particular acquisition. The SEC requires audited financial statements of the company for three years generally (or since its inception, if it has existed for less than three years), but these financial statements can be comprised of not less than three, two, and one year(s) for not less than 60%, 80%, and 90%, respectively, of the constituent businesses. This case-by-case exemption allows currently insignificant businesses, as measured at the time of the filing of the registration statement, to be excluded.

Other Special Cases

Certain types of acquisitions are subject to specialized treatment. For example, acquisitions of real estate operations are covered under Rule 3-14 if they provide rental or mortgage income rather than supporting another type of income-producing service. Such properties, which generate revenues solely through leasing, include office, apartment, and industrial buildings as well as shopping centers and malls. Properties that produce income through other means incidental to the real estate itself, such as hotels, golf courses, or auto dealerships, are not included. Depending on the circumstances, Rule 3-14 requires either three years of audited income statements or only one year and additional textual disclosures. Acquisitions by real estate investment trusts (REITs) are covered under Rule 3-15, which clarifies that reporting of gain or loss on a sale or disposal is based on whether the real estate trust qualifies as a discontinued operation.

Companies that are or are required to be registered as management investment companies must comply with Rule 3-18, which requires an audited balance sheet as of the end of the most recent fiscal year, an audited statement of operations and an audited statement of cash flows for that year, and audited statements of changes in net assets for the two most recent fiscal years. Rule 3-18 also requires updated information for interim periods depending on the date of filing.

Foreign private issuers (as defined by Rule 405 under the Securities Act) must comply with Rule 3-20, which requires prominent disclosure regarding the currencies to be used in financial statements and supplemental information to quantify the influence of a hyperinflationary environment, if applicable.

Pro Forma Financial Information

In addition to financial statements, pro forma financial information complying with Article 11 must be included when a material acquisition would trigger the need for acquired business financial statements under Rule 3-05. Rule 11-01(c) provides that no pro forma information is needed if separate financial statements of the acquired business are not included in a Form 8-K filing.

Pro forma financial information is intended to illustrate the continuing impact of a transaction by showing how the specific transaction might have affected historical financial statements had the acquisition occurred at the beginning of the acquirer's most recently completed fiscal year or the earliest period presented. In particular, Article 11 requires:

- A condensed pro forma balance sheet as of the end of the most recent period for which a consolidated balance sheet of the acquirer is required, unless the transaction is already reflected in that balance sheet; and
- A condensed pro forma income statement for the acquirer's most recently completed fiscal year and the most recent interim period of the acquirer, unless the historical income statement reflects the transaction for the entire period.

Article 11 also requires pro forma financial information in a number of other situations, such as (1) certain dispositions at a greater than 10% significance level (measured under the significance tests discussed above) that are not fully reflected in the financial statements of the acquirer included in a Form 8-K filing; (2) the acquisition of certain investments accounted for under the equity method; and (3) other events or transactions for which disclosure of pro forma financial information would be material to investors.

[25] It is not clear whether a definitive agreement with the target business which includes a "diligence out" provision would imply that an acquisition is probable.
[26] SEC Staff Accounting Bulletin: Codification of Staff Accounting Bulletins, Topic 1.J. provides the examples of nursing homes, hospitals, or cable TV systems.

<u>Certain Key Content Requirements for Pro Forma Financial Information</u>

Rule 11-02 provides extensive specific requirements for the content of pro forma financial information. The pro forma condensed balance sheet should be prepared as if the transaction had occurred on the date of the acquirer's latest historical balance sheet. The pro forma condensed income statements should be prepared as if the transaction had taken place at the beginning of the latest fiscal year included in a Form 8-K filing. The following are a few additional content requirements that are particularly noteworthy:

- Rule 11-02(b)(6) provides that pro forma adjustments related to the pro forma condensed income statement must include adjustments which give effect to events that are (1) directly attributable to the transaction, (2) expected to have a continuing impact on the acquirer, and (3) factually supportable. Adjustments for expected future synergies and cost savings are generally not included.
- Rule 11-02(c)(3) provides that pro forma condensed income statements should be presented using the acquirer's fiscal year-end. If the most recent fiscal year-end of the acquired company differs from that of the acquirer by more than 93 days, the acquired company's fiscal year-end should be brought up to within 93 days of the acquirer's fiscal year-end, if practicable. This may be satisfied by adding subsequent interim period results to the most recent fiscal year-end information and deducting the comparable preceding year's interim period results. Another common approach is to use the acquired company's most recent quarterly information.

<u>Securities of the Acquirer as Consideration</u>

Special requirements arise if the acquirer is offering its securities to the holders of the securities of the business being acquired and registering them on Form S-4 or F-4. If the target is a reporting company under the Exchange Act,[27] or if the acquirer's shareholders are voting on the transaction, the registration statement must include, for the target:

- Balance sheets for the two most recent fiscal years;
- Statements of income and cash flows for each of the three most recent fiscal years; and
- The most recent interim financial information filed on Form 10-Q, except that it need only include cumulative year-to-date information for the latest and comparable interim period.

In the special case where the target business is not a reporting company under the Exchange Act and the shareholders of the acquirer are not voting on the transaction, the significance tests (as discussed above) would be used to determine whether financial statements need to be included. No financial statements are needed at a significance level of 20% or less, unless aggregation applies. However, if the significance level of the acquisition independently exceeds 20%, a registration statement on Form S-4 will need to include financial statements for the latest fiscal year of the target (in conformity with GAAP). In addition, if the target has provided its security holders with GAAP financial statements for either or both of the two fiscal years before the most recently completed fiscal year, then those financial statements must be provided as well.[28]

<u>Acquiring a Portion of a Target</u>

When the acquirer is purchasing "substantially all" of the target's key operating assets, the presumption is that full audited financial statements of the target will still be necessary in order to fully inform investors.[29] In such a case, the specified assets and liabilities that are not being acquired or assumed should still be presented in pro forma financial statements that illustrate the effects of the acquisition.

However, if the acquirer is not purchasing substantially all of the target's assets and liabilities, presenting the complete financial statements of the target may not be useful to investors. Examples include when the target retains significant operating assets or when significant operating assets of the target are going to an entity other than the acquirer. In these cases, audited financial statements should be presented for the acquired component business(es) and should exclude the continuing operations retained by the target. Carve-out financial statements or abbreviated financial statements may be used depending on the facts and circumstances.

In order to use carve-out financial statements, a company must explain why it is impracticable to prepare the full financial statements required by Reg S-X. Generally, carve-out financial statements are appropriate when acquiring a "discrete activity" of the target. A "discrete activity" is a portion of the target's business for which assets and liabilities can be specifically identified and items that cannot be specifically identified (such as debt and indirect expenses) can be reasonably allocated. Such carve-out financial statements should still reflect all assets and liabilities of the target even if not acquired

[27] *See* Form S-4, Item 17(a). *See also* Form F-4, Item 17(a).
[28] *See* Form S-4, Item 17(b)(7).
[29] *See Financial Reporting Manual*, Section 2065.

and should comply with the guidance under SEC Staff Accounting Bulletin: Codification of Staff Accounting Bulletins Topic 1.B.1.

Abbreviated financial statements must include audited statements of assets acquired and liabilities assumed and statements of revenues and direct expenses. This may be appropriate when it is impracticable to provide full financial statements required by Reg S-X. One example would be the acquisition of a product line which is not a stand-alone entity, which has never had separate audited financial statements prepared for it, and for which the target has not maintained the distinct accounts needed to present the full financial statements of the product line. Except in the case of certain oil and gas properties, a request to substitute abbreviated financial statements for full or carve-out financial statements should be directed to the SEC staff before filing.

Discontinued Operations and Other GAAP Retroactive Revisions

As noted above, a disposition that meets a significance test level may also trigger requirements for the disclosure of pro forma financial information. If GAAP would require such a disposition to be treated as a discontinued operation in the financial statements (generally, this occurs when a discrete unit, such as a subsidiary or division, is being disposed of), it may be necessary to revise prior financial statements to reflect the discontinued operation.[30] In most cases, "pre-event financial statements," meaning those of the fiscal year prior to the disposition event, must be retroactively revised and re-issued after financial statements covering the period of the event have been filed.[31] Therefore, if interim financial statements for a fiscal quarter must be included in a registration statement and a disposition event occurred during that fiscal quarter, it may be necessary to file a retroactive revision of the pre-event financial statements.

Recent Developments

The SEC staff has been engaged in a disclosure review process that entails examining whether existing disclosure requirements are repetitive, outdated or should otherwise be revised. The SEC issued a request for comments regarding, among other things, the content of disclosures required under Rule 3-05 and the tests for determining the required disclosures.[32] The SEC specifically requested comments on, among other things, the following:

- The usefulness of the information that is currently required;
- The amount of time that registrants have to provide the information;
- The utility of the significance tests;
- Alternatives to the significance tests;
- Whether foreign private issuers should be subject to similar requirements; and
- The applicability of the requirements to smaller reporting companies and emerging growth companies.

The comment period closed on November 30, 2015. Proposed amendments to Rule 3-05 are expected in the near term as amendments to financial disclosures about acquired businesses are included in the SEC's Fall 2017 agenda of rulemaking actions pursuant to the Regulatory Flexibility Act.

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[30] *See* FASB Accounting Standards Codification 205-20.
[31] *See Financial Reporting Manual*, Section 13100.1.
[32] *See* SEC Release No. 33-9929; 34-75985 (Sept. 25, 2015).

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