

Corporate Finance Alert

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Financial Statement Requirements for a Business Acquired or to Be Acquired – What You Need to Know

Significant levels of accumulated cash have well-positioned many companies to pursue merger and acquisition activity. Potential acquirors and other transaction participants should be aware, in advance of entering into an acquisition transaction, of the Securities and Exchange Commission (SEC) reporting requirements for historical financial statements of the target business and *pro forma* financial information giving effect to the acquisition. These reporting requirements apply to registration statements filed by the acquiror as well as to the acquiror's Current Report on Form 8-K reporting the consummation of the acquisition. As a matter of market practice, the financial reporting requirements applicable to registration statements also generally would be applied to an offering document for an offering exempt from SEC registration, including an offering of high-yield debt pursuant to Rule 144A.

Awareness of these requirements facilitates advance planning, including requiring cooperation from the seller and the seller's accountants as part of the acquisition agreement. Advance planning and preparation is especially important for acquirors that intend to access the capital markets either to finance the acquisition or shortly after the closing of the acquisition.

Historical Financials of the Acquired or to Be Acquired Business

This section discusses the requirements under Rule 3-05 of Regulation S-X as it applies to the filing of new registration statements for capital raising transactions. As further discussed below under "Special Considerations," for existing registration statements, an SEC registrant generally has no specific obligation to update the prospectus except as provided in the case of a "fundamental change." However, notwithstanding that the SEC rules may not require the prospectus to be updated with historical financial statements of the target¹ or *pro forma* financial information, acquirors contemplating financing an acquisition by a takedown from an existing registration statement will need to discuss with the underwriters for the offering whether historical and/or *pro forma* financial information will be required for marketing purposes and, together with their counsel, also make an assessment of the materiality of such financial information, independent of SEC and marketing requirements.

If securities are being offered to the target's security holders, the historical target financial statement reporting requirements are governed by the instructions to the applicable registration statement form (such as Form S-4), and not by Rule 3-05.² Foreign issuers and businesses also are subject to special rules that should be consulted.³

Questions to Ask Under Rule 3-05

The following factors govern whether, and for what periods, an acquiror is required to present historical financial statements of the target:

- Is a "business" being acquired?
- How significant is the acquired business?
- Has the acquisition occurred or is it probable?

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Generally, historical target financial statements are required to be included in the registration statement if the target constitutes a significant business and the acquisition was consummated 75 days or more prior to the registered offering.⁴ However, in the case of acquisitions significant above the 50% level, historical target financial statements also generally are required to be included in the registration statement if the acquisition is probable or was consummated less than 75 days prior to the registered offering.

The terms “business,” “significant” and “probable” have specific meanings for purposes of the SEC reporting requirements, and these meanings may differ from the definitions of these terms for financial accounting purposes.

Is a ‘Business’ Being Acquired?

Historical financial statements of the target are required in the registration statement only if the target is a “business.” Whether the target is a business depends on whether there is sufficient continuity of the target’s operations before and after the acquisition so that disclosure of the target’s historical results is material to an understanding of the acquiror’s future operations.⁵

There is a presumption that a separate entity, subsidiary or division is a business. In addition, depending on the facts and circumstances, a lesser component, such as a product line or other assets, may be considered a business. The SEC’s analysis of whether the acquired assets constitute a business focuses primarily on whether the nature of the revenue-producing activity associated with the acquired assets will remain generally the same after the acquisition. Consideration also should be given to whether physical facilities, employee base, market distribution systems, sales force, customer base, operating rights, production techniques or trade names will remain the same after the acquisition. If so, it is more likely that the SEC would view the acquired assets as a business.⁶ Acquisitions of real estate operations may be subject either to Rule 3-05 or to the financial statement requirements of Rule 3-14, depending on the type of operation.⁷

The form of the acquisition (*e.g.*, whether a stock purchase or an asset purchase) typically will not affect the determination of whether a business has been acquired for SEC reporting purposes.

What Is the ‘Significance’ of the Acquired Business?

The extent to which historical target financial statements must be included in the registration statement also depends on whether the target is “significant” and, if so, at what level. Three tests are used to determine the significance of the target:⁸

- Investment or purchase price (investment test):
 - *Investment Test.* The investment test compares (1) the total purchase price of the target (adjusted for certain items)⁹ to (2) the acquiror’s pre-acquisition consolidated total assets.
- Proportionate share of total assets (asset test):
 - *Asset Test.* The asset test compares (1) the target’s consolidated total assets to (2) the acquiror’s pre-acquisition consolidated total assets.
- Pre-tax income from continuing operations (income test):
 - *Income Test.* The income test compares (1) the target’s consolidated income from continuing operations before taxes, extraordinary items and cumulative effect of a change in accounting principle and exclusive of any amounts attributable to any non-controlling interest (“pre-tax income”) to (2) the acquiror’s pre-acquisition consolidated pre-tax income.¹⁰

All three of the tests must be performed, and the significance level of the target is based on the highest percentage calculated by the three tests. As a result, acquirors should be alert to the fact that an insignificant acquisition from the perspective of one test may be significant under another test. Such may be the case, for example, when an acquiror with a large asset value but little or no income from continuing operations acquires a target with a small asset value but significant income from continuing operations relative to the acquiror.

As summarized in the chart below, the significance level of the target determines the number of years of historical target financial statements to be included in the registration statement. The calculations under the significance tests are generally based on the target's and the acquiror's most recent annual financial statements.¹¹ In addition, there are numerous interpretational and calculation rules for specific types of transactions. For example, as discussed below under "Special Considerations," there are special rules for multiple insignificant acquisitions and for acquisitions of related businesses.

The investment, asset and income tests are the only acceptable tests for determining significance of the target. The SEC staff will not accept calculations based on other measures, such as EBITDA. The significance tests also may not be performed using "annualized" numbers.

Has the Acquisition Recently Occurred or Is it Probable?

Whether financial statements must be included in the registration statement also depends on when the acquisition occurred or, if it has not yet occurred, whether it is probable. The term "probable" is interpreted to mean "more likely than not." The determination of whether an acquisition is "probable" depends upon the facts and circumstances. For example, some acquisitions may be viewed as probable upon the signing of a definitive acquisition agreement or a binding letter of intent. However, a different conclusion may be reached for other acquisitions depending on customary practice for an acquiror or a particular industry or the closing conditions of the acquisition.¹²

For consummated acquisitions, historical target financial statements are required in a registration statement for a registered offering that occurs 75 days¹³ or more after the acquisition was consummated. For probable acquisitions or acquisitions that were consummated less than 75 days prior to the registered offering (*i.e.*, during the 74-day grace period), historical target financial statements are not required in the registration statement unless the target exceeds the 50 percent significance level on any of the tests, the financial statements have been previously filed by the acquiror or the acquiror is a blank check company.¹⁴

The chart on the following page summarizes the Rule 3-05 financial statement reporting requirements for the acquiror's registration statement based on the outcome of the significance tests described above.¹⁵

continued

Significance Level of the Individual Acquired Business (or Multiple Related Businesses) ¹⁶	Historical Acquired Business Financial Statement Periods	
	Consummated Acquisition	Probable Acquisition
Does not exceed 20 percent (i.e., “insignificant”)	<p><i>No financial statements required</i></p> <p>But see “Special Considerations — Individually Insignificant Acquisitions” below (if the aggregate significance level of individually insignificant acquisitions exceeds 50 percent, the acquiror will be required to include at least the one year of financials referred to under “Exceeds 20 percent but does not exceed 40 percent” below)</p>	<i>No financial statements required</i>
Exceeds 20 percent but does not exceed 40 percent	<ul style="list-style-type: none"> • <i>Audited financial statements: Most recent</i> fiscal year <ul style="list-style-type: none"> – Audited balance sheet as of the end of the most recent fiscal year – Audited statements of operations and related statements of changes in financial position for the most recent fiscal year • <i>Unaudited interim financial statements:</i> Applicable interim period after the end of the most recent fiscal year and comparative period of the prior fiscal year • <i>Within 74-day grace period:</i> Not required if the registered offering is within 74 days after the consummation of the acquisition unless such financial statements have been previously filed by the acquiror or the acquiror is a blank check company¹⁷ • <i>75 days or longer:</i> Generally required if the registered offering is 75 days or more after the consummation of the acquisition¹⁸ 	<i>No financial statements required</i>
Exceeds 40 percent but does not exceed 50 percent	<ul style="list-style-type: none"> • <i>Audited financial statements: Two</i> most recent fiscal years <ul style="list-style-type: none"> – Audited balance sheet as of the end of the two most recent fiscal years – Audited statements of operations and related statements of changes in financial position for the two most recent fiscal years • <i>Unaudited interim financial statements:</i> Applicable interim period after the end of the most recent fiscal year and comparative period of the prior fiscal year <p>Same 74-day grace period as under “Exceeds 20 percent but does not exceed 40 percent” above</p>	<i>No financial statements required</i>
Greater than 50 percent¹⁹	<ul style="list-style-type: none"> • <i>Audited financial statements: Three</i> most recent fiscal years <ul style="list-style-type: none"> – Audited balance sheet as of the end of the two most recent fiscal years – Audited statements of operations and related financials for the three most recent fiscal years • <i>Exception for small targets:</i> If net revenues of the target in its most recent fiscal year are less than \$50 million, only two years of audited statements of operations are required • <i>Exception for EGCs:</i> For emerging growth company (EGC) acquirors that present only two years of financial statements pursuant to the accommodations under the JOBS Act, the SEC has indicated that it will not object if only two years of target historical financial statements are provided in the registration statement for purposes of Rule 3-05, even if the significance tests would otherwise require the acquiror to provide three years of target historical financial statements • <i>Exception for foreign targets:</i> See “Special Considerations — Foreign Targets” below • <i>Unaudited interim financial statements:</i> Applicable interim period after the end of the most recent fiscal year and comparative period of the prior fiscal year • <i>Post-acquisition (even if within 74-day grace period):</i> Generally, no offerings may be consummated (even if pursuant to an already effective registration statement) and no registration statements or post-effective amendments will be declared effective (and WKSIs should not file automatically effective registration statements), until the required financials are filed²⁰ • <i>Major significance:</i> See the discussion below under “Special Considerations — Major Significance” for an overview of the requirements to continue to present historical target financial statements if the target is of major significance 	<i>Same as for consummated acquisition</i>

Special Considerations

Marketing and Disclosure. Notwithstanding that the SEC rules generally do not require the registration statement to include financial statements for 50 percent or less significant acquisitions that are probable or were consummated less than 75 days before the registered offering, if the acquiror is contemplating a registered offering or an underwritten offering exempt from SEC registration (e.g., a Rule 144A offering) of securities, the financial statements to be included in the offering document should be discussed among the deal team early in the offering process. For example, some bank commitment committees may require at least one year of audited annual financial statements of the target, together with appropriate *pro forma* financial information, even if such financial statements would not otherwise be required by SEC rules. In addition, even if historical target financial statements are not required by SEC rules, the underwriters typically will require that some historical and *pro forma* financial information be included for marketing purposes in cases in which the acquisition is significant in order to illustrate the operating results of the companies on a combined basis. Further, acquirors and their counsel should make an assessment of the materiality of such financial information, independent of SEC or marketing requirements, to determine whether historical and/or *pro forma* financial information should be included in order to make the offering document free of material misstatements or omissions.

In addition to any historical and *pro forma* financial statements, the disclosure most likely will need to include some discussion on the integration of the target and the consequences of the acquisition, including on the acquiror's business and liquidity. In some cases, a supplemental discussion in MD&A based on *pro forma* financial information may be appropriate.²¹

Similarly, for existing registration statements, although an SEC registrant has no specific obligation to update the prospectus except in the case of a "fundamental change,"²² for significant acquisitions for which historical target financial statements would not otherwise be required, the acquiror should consider whether the consummation, or probability of consummation, of the acquisition would constitute such a "fundamental change" such that a post-effective amendment to the registration statement would be necessary. The acquiror also should consider whether individually insignificant acquisitions occurring subsequent to effectiveness of the registration statement, when combined with individually insignificant acquisitions that occurred after the most recent audited balance sheet in the registration statement but prior to effectiveness, may be of such significance in the aggregate that an amendment is necessary. In addition, as described in the chart above, even during the 74-day grace period, offerings pursuant to effective registration statements may not proceed if the significance of a consummated or probable acquisition exceeds 50% and the required financial statements have not been filed.²³

Form and Content. The form and content of the required financial statements of the target, even if not an SEC registrant, generally are the same as would be required if the target were an SEC registrant.²⁴ In addition, the required financial statements must satisfy the age-of-financial statement, or "staleness" rules.²⁵ "Staleness" means the point in the quarter (in the case of first and second quarter financial statements) or the point in the subsequent fiscal year (in the case of third quarter financial statements) when the prior quarter's financial statements become so dated that the registration statement needs to be updated with the subsequent quarter's or the full fiscal year's financial statements, respectively. The particular staleness date depends on whether the target is a large accelerated filer, an accelerated filer or neither, and generally, but does not always, align with the corresponding periodic report filing deadlines.²⁶

Historical audited balance sheets of the target are not required when the acquiror's most recent audited balance sheet is for a date after the date of consummation of the acquisition. Historical income statements of the target also generally are not required once the operating results of the target have been reflected in the audited income statements of the acquiror for at least nine months,²⁷ unless those target financial statements have not been previously filed by the acquiror (e.g., on Form 8-K) or the target is of "major significance" to the acquiror. Although the acquisition may be of major

significance at lower thresholds due to factors specific to the particular acquiror, the SEC Staff generally presumes that the acquisition is of “major significance” at levels of 70 percent or greater as further described below.

Major Significance. If the target is of “major significance” to the acquiror, the SEC staff generally takes the view that historical target financial statements should continue to be presented for the number of periods prior to the acquisition such that the combination of pre- and post-acquisition periods presented cover three years and any interim period, in each case as specified in S-X Rule 3-02. A target is of major significance if the omission of the historical target financial statements would materially impair an investor’s ability to understand the historical financial results of the acquiror.²⁸

The SEC staff presumes that this is the case and that historical target financial statements therefore should continue to be presented if the target’s significance was:

- at least 70 percent but less than 80 percent and the target’s results have not been included in the acquiror’s audited results for at least 21 months; or
- at least 80 percent and the target’s results have not been included in the acquiror’s audited results for at least 33 months.²⁹

Related Businesses. The acquisition or probable acquisition of a group of related businesses is treated as a single business combination for purposes of the significance tests. Businesses are related if any of the following applies:

- They are under common control or management prior to the consummation of the acquisition.³⁰
- Acquisition of one business is conditioned on the acquisition of each other business.
- Each acquisition is conditioned on a single common event.

If any of the aggregate significance thresholds exceeds the applicable Rule 3-05 significance levels, historical financial statements for each acquired or to be acquired related business must be presented even for those that individually fall below such level (except that businesses that are under common control or management may be presented on a combined basis).³¹

Individually Insignificant Acquisitions. If an acquiror has acquired two or more “individually insignificant” businesses, the acquiror must test the individually insignificant businesses for significance in the aggregate. In performing the test, the acquiror should take into account not only the individually insignificant (less than the 20 percent significance level) acquisitions consummated since the balance sheet date but also individually insignificant probable acquisitions and significant acquisitions for which financial statements are not yet required because of the 75-day rule in Rule 3-05. If the aggregate significance level of the insignificant acquisitions and the significant acquisitions for which financial statements are not yet required exceeds 50 percent, the acquiror will be required to include in the registration statement historical financial statements for the majority of those acquired or to be acquired targets (*i.e.*, targets that constitute more than 50 percent of the aggregate investment, assets or pre-tax income, as applicable).³² The acquiror may choose to evaluate significance for purposes of the foregoing by using the *pro forma* financial information filed on Form 8-K in connection with a previous significant acquisition.³³

Acquisition of Selected Parts of an Entity. If an acquiror acquires substantially all of a selling entity’s key operating assets, full audited financial statements of that entity as described above generally are required, and the *pro forma* financial information presenting the effects of the acquisition would eliminate the specific assets and liabilities not acquired or assumed by the acquiror. However, if the acquiror is acquiring only selected parts of a selling entity that do not represent substantially all of that entity’s key operating assets (*e.g.*, the acquisition of a component business or division of a larger selling entity), audited financial statements should only be presented for the acquired component business or division, excluding the continuing operations retained by the selling entity. These financial statements are referred to as “carve-out” financial statements. The view of the SEC staff is that carve-out financial statements may be appropriate when the acquired business represents a discrete activity of the selling entity for which assets and liabilities are specifically identifiable and there is a reasonable basis to allocate corporate

Form 8-K Financial Statement Requirements for Acquisitions

The same factors and tests are applied to determine historical target financial statements and *pro forma* financial information to be included in the Form 8-K reporting the acquisition of a significant business. However, there are some differences:

- No Form 8-K requirement to file historical target financial statements for probable acquisitions or, except in the case of certain shell companies, to file financial statements prior to the end of the 74-day grace period, even if the target exceeds the 50% significance level.
- No Form 8-K requirement to file financial statements of individually insignificant targets, unless they are related businesses (as defined in Rule 3-05(a)(3)) and are significant in the aggregate.³⁶
- An initial Form 8-K under Item 2.01 describing the acquisition must be filed within four business days after consummation of the acquisition. If the required historical target financial statements are not filed with this initial filing or have not otherwise been previously reported by the registrant,³⁷ they must be filed by amendment to the Form 8-K within 71 calendar days after the due date of the initial Form 8-K filing (*i.e.*, a total period of 71 calendar days plus four business days after the consummation of the acquisition).³⁸
- A Form 8-K under Item 2.01 also is required to be filed, but historical target financial statements and *pro forma* financial information are not required to be filed with the Form 8-K, upon completion of the acquisition of a significant amount of assets, other than in the ordinary course of business, that does not meet the definition of a business.³⁹ For purposes of this filing requirement, an asset acquisition is significant if the acquiror's equity in the net book value of such assets or the amount paid for such assets exceeded 10% of the acquiror's pre-acquisition consolidated total assets.
- Note that the requirements for a Form 8-K reporting dispositions of a significant business or of significant assets differ from the requirements described above for acquisitions.⁴⁰

overhead and other items that are not specifically identifiable to the acquired business.³⁴

In certain circumstances, full financial statements or carve-out financial statements may not be practicable to prepare (*e.g.*, when the acquired business is a small portion, product line or working interest in a property of a much larger business and separate financial records and accounts were not maintained for the acquired business). In these circumstances, the SEC staff may allow audited statements of assets acquired and liabilities assumed and statements of revenues and direct expenses instead of full financial statements or carve-out financial statements. The acquiror must make a specific request to the SEC, explaining the impracticability in the request and confirming the ability to meet the SEC's requirements with respect to such statements of assets acquired and liabilities assumed and statements of revenues and direct expenses, and receive SEC approval prior to filing such statements.³⁵ However, what constitutes an impracticability in the view of the acquiror (*e.g.*, the expense of preparing full financial statements) may not constitute an impracticability from the SEC's perspective (which gives as an example of impracticability the situation described earlier in this paragraph), and, as a result, such requests generally are not successful.

Foreign Targets. If the target is a foreign business, financial statements of the business meeting the requirements of Item 17 of Form 20-F will satisfy the requirements of Rule 3-05. Rule 1-02(l) of Regulation S-X defines a "foreign business" as one that is majority owned by persons who are not citizens or residents of the United States and is not organized under the laws of the United States or any state thereof, and either (1) more than 50% of its assets are located outside the United States, or (2) the majority of its executive officers and directors are not U.S. citizens or residents. Ownership and director/officer status are determined by the attributes of the ultimate holding company for the target; however, in carve-out situations, a facts-and-circumstances analysis is required.

Financial statements must be as of a date within nine months of the effective date of the registration statement. If the date of the Form 8-K or effective date of the Securities Act registration statement presenting target financial statements is more than nine months after the fiscal year-end of the target, interim financial statements covering a period of at least six months must be provided in addition to the required annual financial statements. If target has provided financial information reporting revenues and income for an annual or interim period more current than otherwise required by Form 20-F to shareholders, exchanges or others in any jurisdiction, such financial information should be included in the SEC filings.

If target financial statements are prepared other than in accordance with U.S. GAAP or International Financial Reporting Standards as issued by the IASB (as confirmed in the auditor's report thereon) and the significance of the foreign target exceeds 30%, they must be reconciled to U.S. GAAP, subject to certain exceptions.

Other Financial Statements Requirements

Even if Rule 3-05 does not require historical target financial statements to be included in the acquiror's registration statement, the acquiror should consider other SEC rules that may nonetheless require the acquiror to include historical target financial statements in the registration statement and, in some cases, its Form 10-K or Form 10-Q. For example, if any of the circumstances below apply to the acquiror, the acquiror should review the applicable SEC requirements.

- *Rule 3-09 (Financial statements of subsidiaries not consolidated and 50 percent or less owned persons)* — the acquiror makes a significant investment in a business, but that business is 50 percent or less owned or is otherwise accounted for using the equity method.
- *Rule 3-10 (Financial statements of guarantors and issuers of guaranteed registered securities)* — the acquiror has outstanding registered debt securities and the target will become a guarantor of those debt securities or the acquiror or the target will be issuing guaranteed registered debt securities.
- *Rule 3-14 (Special instructions for real estate operations to be acquired)* — the acquiror has acquired or proposes to acquire one or more real estate operations (see the prior discussion herein).
- *Rule 3-16 (Financial statements of affiliates whose securities collateralize a registered issue)* — the acquiror has outstanding registered debt securities, or will be issuing registered debt securities, secured by pledges of subsidiary equity interests.

Pro Forma Financial Statements

When an acquisition of a significant business has occurred in the acquiror's most recent fiscal year or subsequent interim period or is probable and historical target financial statements are required in the registration statement, *pro forma* financial information complying with Article 11 of Regulation S-X also generally will be required in the registration statement.⁴¹

When is Pro Forma Financial Information Required?

The following factors govern whether an acquiror is required to include *pro forma* financial information in the registration statement:⁴²

- Is the acquisition of a significant business?
- Are historical financial statements of the acquired or to be acquired target included in the filing?
- Is the acquisition reflected in the acquiror's historical financial statements?

The same factors and tests as described above for historical target financial statements are applied to determine whether the target is a business and to calculate the significance of the target. If any of the three significance tests exceeds 20 percent, *pro forma* financial information is required. However, unlike for historical target financial statements, the level of significance does not affect the number of periods for which *pro forma* financial information must be presented.

Pro forma financial information is not required in the registration statement if historical target financial statements are not required in the filing.⁴³ *Pro forma* financial information also is not required to the extent that the acquiror's historical financial statements already reflect the transaction, as further described in the *pro forma* presentation requirements summarized below.

If target historical financial statements for significant acquisitions are included in the registration statement, acquirors also should consider whether the *pro forma* financial information would be misleading without giving effect to all individually insignificant acquisitions. Also, if an acquiror presents the financial statements of an individually insignificant business, the SEC Staff encourages acquirors to also include Article 11 *pro forma* information in the filing.

The deadlines and grace periods for filing the *pro forma* financial information are the same as those for the filing of the historical target financial statements.

***Pro Forma* Presentation Requirements**

The purpose of *pro forma* financial information is to enable investors to understand and evaluate the impact of a transaction by illustrating how that transaction may have affected the acquiror's historical financial statements.

In particular, Article 11 requires:⁴⁴

- a *pro forma* condensed balance sheet as of the end of the most recent period for which a consolidated balance sheet of the acquiror is required, unless the transaction is already reflected in that balance sheet; and
- a *pro forma* condensed statement of operations for the acquiror's most recently completed fiscal year and the most recent interim period of the acquiror, unless the acquiror's historical statement of operations reflects the transaction for the entire period. A *pro forma* condensed statement of operations also may be filed (but is not required) for the corresponding interim period of the prior fiscal year.

The *pro forma* condensed balance sheet is prepared as if the transaction had occurred on the date of the acquiror's latest historical balance sheet included in the registration statement. The *pro forma* condensed statement of operations is prepared as if the transaction had taken place at the beginning of the acquiror's latest fiscal year for which a statement of operations is included in the registration statement.

The *pro forma* statement of operations should be presented using the acquiror's fiscal year-end. If the most recent fiscal year-end of the target differs from the acquiror's most recent fiscal year-end by more than 93 days, the target's statement of operations should be brought up to within 93 days of the acquiror's most recent fiscal year-end, if practicable, by adding subsequent interim results to the fiscal year's data and deducting the comparable preceding year's interim results, with appropriate disclosure. Additional quantitative and narrative disclosure about gross profit, selling and marketing expenses, and operating income of any period excluded from or included more than once may be necessary to disclose the effects of unusual charges or adjustments in the omitted or double-counted period.⁴⁵

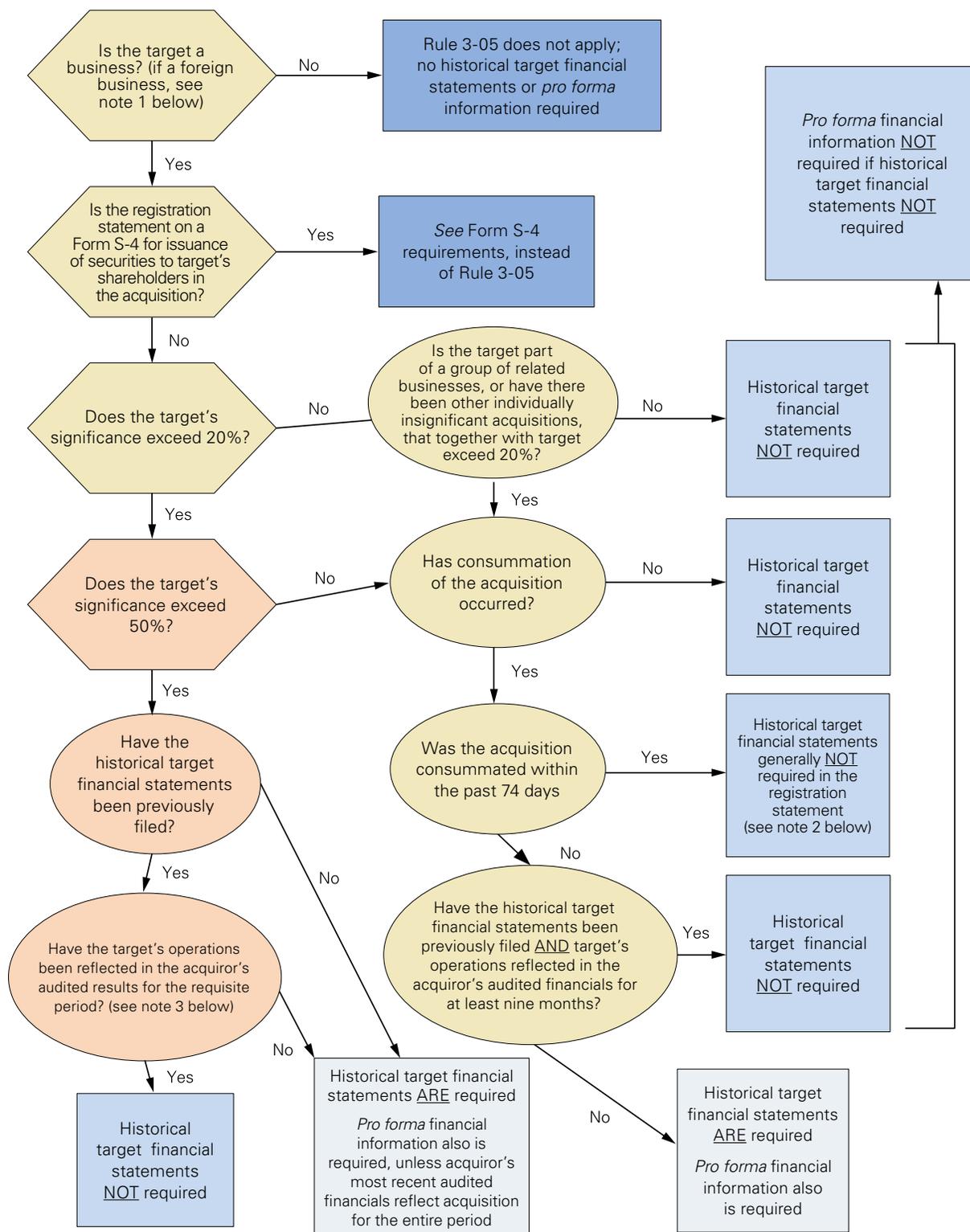
Rule 11-02 provides extensive specific requirements for the content of *pro forma* financial information and related adjustments and should be reviewed carefully in the context of any particular transaction.

* * * * *

In conclusion, acquirors, their bankers and other transaction participants should be aware of the SEC reporting requirements for historical target financial statements and *pro forma* financial information in advance of entering into an acquisition transaction, particularly if the acquiror intends to access the capital markets to fund the acquisition or shortly after the closing of the acquisition. Awareness of these requirements facilitates advance planning, including negotiating provisions in the acquisition agreement for cooperation from the seller and the seller's accountants in preparing the required historical target financial statements and *pro forma* financial information and having the seller's accountants provide the necessary review and comfort with respect to the target historical financial statements and any other target-related financial information included in the offering document. Such advance planning will better position the acquiror to more quickly access the capital markets, without a delay associated with preparing, and performing comfort and other procedures with respect to, the required historical financial statements or *pro forma* financial information.

A basic flowchart is included on the next page to provide an overview of the key factors discussed above and the necessary determinations.

Are Historical Target Financial Statements and *Pro Forma* Financial Information for an Acquisition that has Occurred or Is Probable Required in a Registration Statement?



Note 1: If the target business is a foreign business, financial statements of the business meeting the requirements of Item 17 of Form 20-F will satisfy the requirements of Rule 3-05.

Note 2: If the acquisition occurred within the 74-day grace period, historical target financials are not required unless the financial statements have been previously filed by the acquiror or if the acquiror is a blank check company. However, historical target financial statements are required to be filed on Form 8-K no later than the expiration of the 74-day grace period (i.e., no later than 75 calendar days, or technically the sum of four business days plus 71 calendar days, after the consummation of the acquisition).

Note 3: The requisite period is at least (i) nine months if the target's significance is greater than 50% but less than 70%, (ii) 21 months if the target's significance is at least 70% but less than 80% and (iii) 33 months if the target's significance is at least 80%.

END NOTES

- 1 As used herein, references to “target” are to the acquired (or to be acquired) business and, as described herein, may include a separate entity or a subsidiary, division or substantially all of the key operating assets of a larger selling entity, in each case that constitutes a business.
- 2 Under Form S-4, for example, the number of periods to be presented (and the need to audit the annual financials presented) depend on whether the target is an SEC reporting company or a non-reporting company and, in the case of a non-reporting company, whether the target’s shareholders are voting on the transaction. In addition, whether the target’s financial statements may comply with the smaller reporting company rules will be governed by whether the target, and not the acquiror filing the registration statement, meets the smaller reporting company requirements. If a Form S-4 is being used to register securities for another transaction, such as an A/B debt exchange offer, and the acquiror has previously consummated an acquisition or an acquisition is probable, the provisions of Rule 3-05 would apply. For smaller reporting companies, Rule 8-04 of Regulation S-X sets forth the requirements for historical target financial statements, which requirements are similar, but not identical, to those under Rule 3-05.
- 3 See “Special Considerations — Foreign Targets” herein. Also see, for example, Rule 3-05(c), Form 20-F (Items 8 and 17) and Sections 2015 and 2055.1 and Topic 6 (e.g., Sections 6220 and 6410) of the Division of Corporation Finance Financial Reporting Manual and Final Rule: *Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Accounting Standards Without Reconciliation to US GAAP*, SEC Release No. 33-8879 (December 21, 2007).
- 4 For purposes of Rule 3-05, references to the timing of the registered offering mean the date of the final prospectus or final prospectus supplement as filed with the SEC (Rule 3-05(b)(4)(i)). For practical purposes, the financial statement reporting requirements should be assessed any time a new registration statement is being filed or declared (or will become automatically) effective and at the time of any takedown from an existing registration statement.
- 5 Rule 11-01(d) of Regulation S-X.
- 6 Division of Corporation Finance Financial Reporting Manual Section 2010.2.
- 7 Rule 3-14 of Regulation S-X, which is premised on the continuity and predictability of cash flows ordinarily associated with leasing real property, applies to the acquisition or probable acquisition of real estate operations. For purposes of Rule 3-14, the term “real estate operations” refers to properties that generate revenues solely through leasing. Examples include office, apartment and industrial buildings as well as shopping centers and malls. “Real estate operations” excludes the acquisition of properties that generate revenues from operations other than leasing real property, such as nursing homes, hotels, motels, golf courses, auto dealerships, and equipment rental operations, which the SEC considers to be more susceptible to variations in costs and revenues over shorter periods due to market and managerial factors. Rule 3-05 rather than Rule 3-14 is applicable to the acquisition of these types of businesses. Acquired properties subject to triple net leases, whether involving leasing or other activities, have special rules. Division of Corporation Finance Financial Reporting Manual Sections 2305.2 and 2340.
- 8 Rule 1-02(w) of Regulation S-X.
- 9 The total purchase price in this context means the “consideration transferred” (as that term is used in the applicable accounting standard), adjusted to exclude the carrying value of assets transferred by the acquiror to the target that will remain with the combined entity after the business combination. Contingent consideration that represents additional purchase price generally also would be included if the likelihood of payment is more than remote. Pre-acquisition debt and other liabilities of the target assumed in the acquisition generally would be excluded.
- 10 Rule 1-02(w) provides specific computational rules for the income test. For example, if the acquiror’s pre-tax income (but not a pre-tax loss) to be used to perform the test is significantly lower (10 percent or more) than the five-year average of the acquiror’s pre-tax income, then the five-year average should be used, subject to some exceptions. Any loss years should be omitted in computing the average income. In addition, in the case of a single acquisition, if either the acquiror or the target has a pre-tax loss and the other has pre-tax income in the period being used to perform the test, the absolute value of the loss should be used to perform the test. See Division of Corporation Finance Financial Reporting Manual Sections 2015.8 and 2015.9.
- 11 Certain adjustments to the financials may need to be made. For example, intercompany transactions between the acquiror and the target should be eliminated. In addition, if the acquiror made a significant acquisition subsequent to the date of its most recent annual financial statements and filed a Form 8-K that includes the required historical target financial statements and *pro forma* information, the calculation may be made using the *pro forma* annual amounts.

If the target is not an SEC registrant, the annual financial statements used for the significance tests should be prepared as if the target were an SEC registrant, except that if the target's annual financial statements are not audited, they need not be audited to perform the significance tests. However, if historical target financial statements are required in the registration statement, the target's annual financial statements must be audited.

- 12 The SEC staff does not provide a definition of "probable"; rather, the Division of Corporation Finance Financial Reporting Manual Section 2005.4 states that an assessment of probability requires consideration of all available facts, and that an acquisition is probable where the acquiror's financial statements standing alone would not provide investors with adequate financial information with which to make an investment decision.
- 13 The "75-day" period as it relates to registration statements is 75 calendar days after the consummation of the acquisition. However, the SEC staff generally takes the position that for purposes of determining whether financial statements of a target are required in a registration statement, "75 calendar days" is substantially equivalent to four business days plus 71 calendar days, which would be the deadline to file the financial statements on the Form 8-K reporting the consummation of the acquisition. The "75-day" period therefore may be longer than 75 calendar days as a result of weekends or SEC holidays. See Note to Section 2050.1 of the SEC Division of Corporation Finance Financial Reporting Manual. See also "Form 8-K" below.
- 14 Rule 3-05(b)(4)(i).
- 15 There are special rules for IPO registrants that meet certain conditions. These rules allow those registrants to apply Staff Accounting Bulletin 80, instead of Rule 3-05, in their initial registration statement. SAB 80 may result in different financial statements being required than under Rule 3-05.
- 16 The results of the significance tests should not be rounded.
- 17 This grace period does not apply to offerings made by blank check companies pursuant to Rule 419 under the Securities Act of 1933 (Securities Act).
- 18 Exceptions are available for certain types of offerings pursuant to registration statements that became effective prior to the consummation of the acquisition. The following offers and sales of securities may be made 75 days or more after the consummation of the acquisition, pursuant to registration statements that were effective prior to the acquisition, notwithstanding that the required historical target financial statements have not been filed: (i) offerings and sales of securities upon the conversion of outstanding convertible securities or upon the exercise of outstanding warrants or rights; (ii) dividend or interest reinvestment plans; (iii) employee benefit plans; (iv) transactions involving secondary offerings by parties unrelated to the target; and (v) sales of securities pursuant to Rule 144. See Division of Corporation Finance Financial Reporting Manual Section 2050.7 (including the note thereto) and the Instruction to Item 9.01 of Form 8-K.
- 19 For smaller reporting companies, there are only three relevant ranges of significance under Rule 8-04, instead of the four ranges of significance under Rule 3-05: (i) does not exceed 20 percent; (ii) exceeds 20 percent but does not exceed 40 percent; and (iii) exceeds 40 percent. For smaller reporting companies, a distinction is not made between acquisitions in excess of the 40 percent significance level and acquisitions in excess of the 50 percent significance level; rather, the financial statement requirements for acquisitions in excess of the 40 percent significance level also generally apply to acquisitions in excess of the 50 percent significance level.

In addition, for emerging growth companies, the SEC has indicated that it will not object if only two years of target historical financial statements are provided in the registration statement for purposes of Rule 3-05, even if the significance tests result in a requirement to provide three years of financial statements. See Division of Corporation Finance, "Jumpstart Our Business Startups Act Frequently Asked Questions," April 16, 2012, Question 16.

- 20 Exceptions are available for certain types of offerings. See Note 18 above, except that during the 74-day grace period, transactions involving any secondary offerings are permitted and are not limited to secondary offerings by parties unrelated to the target. See Division of Corporation Finance Financial Reporting Manual Section 2050.3.
- 21 An MD&A technically is not required for financial statements filed to comply with Rule 3-05, however, in some cases an MD&A may be required based on the registration form requirements (e.g., Form S-4) or for marketing purposes or to address disclosure concerns. See also Division of Corporation Finance Financial Reporting Manual Section 9220.
- 22 Item 512(a) of Regulation S-K. The SEC has not formally defined the term "fundamental change." However, a fundamental change generally is considered to mean a change that is something more than just a material change. Possible examples

- include a change in the business or operations of the company that would necessitate a restatement, changes of control, a particularly significant acquisition or disposition and other changes that are of central importance or go to the key nature of the company's business or operations. See Adoption of Integrated Disclosure System, SEC Release No. 33-6383 (Mar. 11, 1982). As a point of reference, the view of the SEC generally is that the updating provided by the annual financial statements and related MD&A in a Form 10-K would constitute a fundamental change, but that the quarterly financial statements and related MD&A in a Form 10-Q would not constitute a fundamental change unless there is a significant departure from prior trends.
- 23 See Division of Corporation Finance Financial Reporting Manual Sections 2045.3, 2045.4, 2050.3 and 2050.5.
 - 24 See Rules 3-01 and 3-02 of Regulation S-X. Including or incorporating by reference a target's audited historical financial statements into the acquiror's registration statement will require a consent from the target's auditors.
 - 25 For an overview of SEC financial statement staleness dates, see Skadden, Arps, Slate, Meagher & Flom LLP [Corporate Finance Alert "2013 SEC Filing Deadlines and Financial Statement 'Staleness' Dates."](#) See also Division of Corporation Finance Financial Reporting Manual Section 2045.5.
 - 26 Although the staleness date for a target's financial statements is determined based on the status of the target (as a large accelerated filer, an accelerated filer or neither), if the acquiror has a status that requires the acquiror to update its financial statements sooner than the target would be required to update its financial statements (*e.g.*, the acquiror is a large accelerated filer and the target is a non-accelerated filer), the acquiror may need to have available the target's financial statements, and the related *pro forma* financial information, on the same accelerated timeline if the acquiror wants to be in the market on or shortly after the acquiror's periodic report filing deadline.
 - 27 This nine-month requirement reflects the interplay between Rule 3-05(b)(4)(iii) and Rule 3-06. Rule 3-06 permits a registrant to provide audited financial statements of a target for a period of nine to 12 months to satisfy the one year requirement under Rule 3-05.
 - 28 Rule 3-05(b)(4)(iii) and (iv).
 - 29 Division of Corporation Finance Financial Reporting Manual Section 2040.2. Again, these periods reflect the interplay between Rule 3-05(b)(4)(iii) and Rule 3-06 (which by extension of the nine month reference therein permits a registrant to use at least 21 months to satisfy a two-year financial statement requirement and at least 33 months to satisfy a three-year financial statement requirement).
 - 30 Rule 3-05(a)(3).
 - 31 The required financial statements of related businesses may be presented on a combined basis for any periods for which they are under common control or management for the entirety of such period. See also Division of Corporation Finance Reporting Manual Section 2020.8 and the related notes.
 - 32 Rule 3-05(b)(2)(i); see also Division of Corporation Finance Financial Reporting Manual Sections 2035.2 and 2035.3.
 - 33 However, an acquiror may not circumvent the requirements with respect to individually insignificant acquisitions by filing a Form 8-K containing financial statements of one or more insignificant businesses and then test the significance of the remaining insignificant businesses against either the historical or resulting *pro forma* financial statements. If an acquiror has filed a Form 8-K for a previous *significant* acquisition, the 50% aggregation test may be applied against the *pro forma* financial statements included in that Form 8-K. See Division of Corporation Finance Financial Reporting Manual Section 2035.6.
 - 34 See Division of Corporation Finance Financial Reporting Manual Section 2065.3.
 - 35 See Division of Corporation Finance Financial Reporting Manual Section 2065.4. Prior written request must be made to, and approved by, the Office of the Chief Accountant of the Division of Corporation Finance.
 - 36 See Instruction 4 to Item 2.01 of Form 8-K. For acquisitions of insignificant businesses, an acquiror may elect to report the acquisition pursuant to Item 8.01 of Form 8-K, without a requirement to file historical target financial statements or *pro forma* financial information. See Division of Corporation Finance Reporting Manual Section 2040.1.

- 37 Rule 12b-2 under the Exchange Act of 1934 (Exchange Act) defines the term “previously reported” to mean previously reported on a statement under Section 12 of the Exchange Act, a report under Section 13 or 15(d) of the Exchange Act, a definitive proxy statement under Section 14 of the Exchange Act or a registration statement under Securities Act.
- 38 The 74-day grace period for filing target financial statements on a Form 8-K does not apply to acquirors that are shell companies (other than business combination related shell companies), as such terms are defined in Rule 12b-2 under the Exchange Act and Rule 405 under the Securities Act. Accordingly, such shell companies are required to file the required historical target financial statements and any required *pro forma* financial information with the initial Form 8-K.
- 39 Item 2.01 of Form 8-K.
- 40 A disposition of a business is “significant” at a 10 percent level, not the 20 percent level for acquisitions. Rule 3-05 does not apply to dispositions, but *pro forma* financial information may still be required for a disposition of a significant business even though there are no required historical target financial statements. The 74-day grace period does not apply to the filing of required *pro forma* information for a disposition of a significant business; the *pro forma* financial information giving effect to the disposition is required to be filed with the initial Form 8-K (*i.e.*, within four business days following the consummation of the disposition). See Rule 11-01(b)(2) and Items 2.01 and 9.01 of Form 8-K.
- 41 Although the specific rules of Article 11 do not apply to smaller reporting companies, those companies may wish to consult Article 11 for guidance when preparing *pro forma* financial statements required by Rule 8-05 for business acquisitions. Smaller reporting companies should present *pro forma* information for other current or probable transactions if that presentation would be material to investors.
- 42 Article 11 also requires *pro forma* financial information in other situations not necessarily related to Rule 3-05, including certain dispositions and other events or transactions for which disclosure of *pro forma* financial information would be material to investors.
- 43 Rule 11-01(c).
- 44 Rule 11-02.
- 45 Rule 11-02(c)(3) and Division of Corporation Finance Financial Reporting Manual Section 3330.

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