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Financial Statements Triggered by Acquisitions—What Do You Need?

A Practical Guide for US Public Companies, Part I

Significant acquisitions trigger specific financial statement requirements for the acquiring company. Part I of this publication covers key concepts and practice points for determining if an acquisition is significant and what target and pro forma financial statements are required. [Part II](#) addresses when the financial statements need to be filed or updated and under what circumstances securities of the acquiring company can be offered before the financial statements are available. This is part of our series on [Financial Statement Triggers](#).

Overview

Financial statement requirements in connection with acquisitions arise from both SEC rules and market practice. This publication focuses on US public companies that are timely in their SEC filings. Some of the rules differ for companies that are planning their IPO, smaller reporting companies, shell companies, blank check companies or foreign issuers. We also do not address merger proxies or exchange offer registration statements, which are governed by separate rules.

This publication outlines the general framework. Definitive advice on a particular situation requires a review of the SEC's rules and the detailed guidance in the SEC Staff Financial Reporting Manual as well as consultation with the auditors. There are many exceptions to the general rules. Notable examples include acquisitions that do not involve a target business (such as a separate entity or division) but only a collection of assets without a continuation of the revenue-producing activity, acquisitions of less than substantially all of the assets and liabilities of another entity, and transactions involving a reverse acquisition or a GAAP predecessor. In addition, somewhat different rules apply to the acquisition of real estate operations and oil and gas properties.

The SEC's Three Significance Tests

Rule 3-05 of Regulation S-X employs three different tests to determine the significance of an acquisition to the acquiring company, all run using annual consolidated financial statements. The significance tests are defined by the following fractions, expressed as percentages. "Company" refers to the acquiring company.

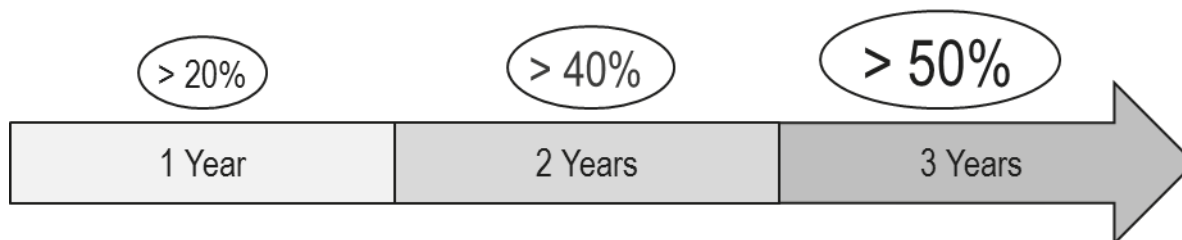
Investment Test	Asset Test	Income Test
$\frac{\text{Purchase Price}}{\text{Company Total Assets}}$	$\frac{\text{Target Total Assets}}{\text{Company Total Assets}}$	$\frac{\text{Target Pre-Tax Income}^*}{\text{Company Pre-Tax Income}^*}$

* From continuing operations,
excl. noncontrolling interests

- **Pre-tax income definition.** Pre-tax income for purposes of the income test is defined as income from continuing operations before income taxes exclusive of amounts attributable to any noncontrolling interests. For historical reasons, the definition also backs out extraordinary items and the cumulative effect of a change in accounting principle, although both have little practical relevance today. US GAAP no longer recognizes extraordinary items, and changes in accounting principle generally result in a retrospective revision of prior period results rather than in a separate cumulative effect line item in the most recent period.
- **Never include target in denominator.** The denominator is generally based on the acquiring company's most recent annual financial statements, as further discussed below. It is never adjusted to include the target.
- **Use most recent annual financial statements.** Generally, significance is tested using the acquiring company's and the target's most recent pre-acquisition annual financial statements. If the acquiring company's annual financial statements have subsequently been revised to reflect discontinued operations or a change in accounting principle, the revised numbers may have to be used depending on the situation. If the acquiring company has previously completed another significant acquisition for which it has filed target and pro forma financial statements, it may calculate significance for a subsequent acquisition by comparing the subsequent target's historical financial statements to the acquiring company's pro forma annual financial information. The SEC staff permits this only if the previous acquisition closed after the date of the annual financial statements.
- **Use five-year average if most recent year income is a negative outlier by 10% or more.** If the acquiring company's pre-tax income for the most recent fiscal year is 10% or more lower than the average over the last five fiscal years, then this average should be used. In calculating the average, loss years are assigned a value of zero, but the denominator remains five. If the acquiring company's pre-tax income for the most recent fiscal year was a loss, compare the absolute value with the five-year average. The target's income is never averaged.
- **Use absolute values for losses.** If either the acquiring company or the target reported a pre-tax loss and the other reported pre-tax income, compare the absolute values.
- **Prorate target assets and income in partial acquisitions.** If the acquiring company is acquiring less than 100% of the target, include only its proportionate share of the target's total assets or pre-tax income in the numerator of the relevant test. If the acquiring company increases its investment in a target relative to the prior year, the test is based on the increase in the acquiring company's proportionate share. Step acquisitions which are part of a single plan to be completed within a twelve month period should be aggregated.
- **Aggregate targets in certain cases.** Acquisitions of related businesses must always be aggregated for purposes of the significance tests. Businesses are treated as related if they are under common control and management or if their acquisitions are dependent on each other or on a single common event. Acquisitions of unrelated businesses may need to be aggregated for a registration statement or offering (but not for the acquiring company's regular ongoing reporting) if together they exceed 50% significance. We discuss this in [Part II](#).
- **Identify taxes attributable to minority interests.** If there are noncontrolling interests that need to be eliminated, note that the noncontrolling interests line on the face of the income statement is generally presented on an after-tax basis. The notes to the financial statements may break out taxes attributable to noncontrolling interests.

Target Financial Statements: Required If Significance Exceeds 20%

If the significance level of an acquisition exceeds 20% on any of the three significance tests, target and pro forma financial statements will generally be required to be filed. If target financial statements are required, they generally need to cover between one and three fiscal years on an audited basis, depending on the highest significance level exceeded under any of the three tests, as follows:



In addition to the audited annual periods, target financial statements may need to cover the target's most recent interim period on an unaudited basis. Financial statements for the earliest of the three fiscal years that are required if significance exceeds 50% may be omitted if the net revenues reported by the target for its most recent fiscal year are less than \$50 million.

- **Permitted age of target financials depends on target status and type of filing.** How current the annual and interim financial statements of the target need to be depends on the target's own filer status and the filing type:
 - If the target is itself a US public company that is timely with its SEC filings, the target financial statements in most cases do not need to be more current than the target's most recent 10-K and 10-Q, respectively. If the target is a US private company, the target financial statements need to be as current as the financial statements of a US public company that is not an accelerated filer: annual financial statements need to be updated starting 90 days after the target's fiscal year-end, and the most recent quarter-end covered by the interim financial statements must be within 135 days, except that interim financial statements including the third quarter will be deemed current until the annual financial statements are required to be updated.
 - If the target is a foreign private issuer or foreign business, each as defined by the SEC, the target's annual financial statements must be updated after three months from the target's fiscal year-end. If the foreign target has a US listing, this is one month earlier than the due date of its 20-F annual report. Interim financial statements covering at least six months must be included after nine months from the target's fiscal year-end.
 - The date as of which the permitted age is determined depends on whether the filing occurs for the acquiring company's regular reporting or in connection with registering or offering securities. We discuss this in [Part II](#).
- **Target financials must be S-X compliant even if target is private.** Targets that are considered nonpublic under GAAP are exempt from certain GAAP disclosures that apply to public entities. However, target financial statements for a US target must always comply with the SEC's requirements for public companies. Certain disclosures may therefore need to be added before the target financial statements qualify for filing with the SEC.
- **Audit must comply with US auditing standards even if target is foreign.** If the target qualifies as a foreign business, its financial statements may be presented in non-US GAAP. If significance exceeds 30%, these must

be IASB IFRS or otherwise include a reconciliation to US GAAP. However, although presentation is permitted in IFRS or other foreign GAAP, the audit must comply with US auditing standards. Target auditors may have to perform additional procedures for this purpose before the audit opinion can be filed with the SEC.

Pro Forma Financial Statements: Required If Target Financial Statements Are Required

If the acquiring company is required to file target financial statements, it will also need to file pro forma financial statements that give effect to the acquisition and related transactions, such as debt incurred for the acquisition.

- **Hypothetical rather than actual.** Pro forma financial statements present the balance sheet of the acquiring company as if the acquisition had closed on the date of the acquiring company's most recent annual or interim balance sheet. The income statement is adjusted as if the acquisition had closed at the beginning of the acquiring company's most recent fiscal year for which financial statements have already been issued.
- **No projections or synergies.** Pro forma financial statements are based on historical financial information of the acquiring company and the target, not on projections. Only adjustments that are directly attributable to the transaction, expected to have a continuing impact and factually supportable are permitted by the SEC. Adjustments eliminating one-time transaction costs related to the acquisition are permitted, but cost savings and synergies expected to result from the transaction typically do not qualify for adjustment under SEC standards.
- **Unaudited rather than audited.** Target financial statements need to be audited for the annual periods. Pro forma financial statements, because they present hypothetical rather than actual financial information, are always unaudited, although the acquiring company's auditors can provide comfort with respect to SEC compliance.
- **Only one year presented.** Pro forma financial statements in connection with acquisitions are generally permitted to cover only the acquiring company's most recent audited year and any interim period. The SEC generally does not permit the pro forma presentation of prior years, except prior year information in the pro forma income statement for the interim period. There is an exception for the reorganization of entities under common control.
- **Must be as current as most recent financial statements of the acquiring company.** The most recent pro forma balance sheet and income statement must correspond to the relevant date and period included in the acquiring company's most recent historical financial statements. If the target and the acquiring company have different fiscal years, the target's annual income statement must be updated to a period ending within 93 days of the acquiring company's fiscal year-end in accordance with the SEC's prescribed methodology.
- **Different from supplemental pro forma footnote information required by GAAP.** Completed acquisitions typically trigger supplemental pro forma financial information in the notes to the financial statements. ASC 805 contemplates the disclosure of pro forma revenues and earnings as if the acquisition had closed at the beginning of the fiscal year preceding the current period. This supplemental pro forma financial information follows different rules and is much less detailed than the pro forma financial statements required under the SEC's rules.

Conclusion

This Part I covered how to determine if an acquisition is significant and what financial statements are required. [Part II](#) will address when the financial statements need to be filed or updated and under what circumstances securities of the acquiring company can be offered before the financial statements are available.

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