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DISCLOSURE

Summary of Required Financial Statements of Businesses Acquired or to Be Acquired



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Rule 3-05 of Regulation S-X requires audited financial statements to be filed for a significant business (or a significant group of related businesses) that has been acquired or the acquisition of which is

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The authors note that this article is a general summary of complex area of law and does not purport to be exhaustive.

probable. See below for a discussion of what constitutes (i) "significant," (ii) a "business" and (iii) a "group of related businesses." A group of related businesses is treated as a single business under Rule 3-05; as a result, references below to an "acquisition" or an "acquired business" include groups of related businesses. The term "probable" is not a defined term and is evaluated on a case-by-case basis.

Generally, the period for which the acquired business' financial statements will be required to be filed is determined by the level of the significance of the acquisition.

Registration Statements and Proxies of Acquiror

Whether financial statements of an acquired business (or group of related businesses) must be included in an acquiror's registration statement or proxy depends on the level at which the acquired business meets the conditions for a "significant subsidiary," as defined by Rule 1-02(w) of Regulation S-X. See "Determining Significance" below for an explanation of how significance is calculated.

If the significance of the acquired business:

- ▶ *Does not exceed 20%*—No financial statements required.

- ▶ *Exceeds 20% but not 40%*—Financial statements for the most recent fiscal year, the latest interim period and the corresponding interim period of the preceding year are required.
- ▶ *Exceeds 40% but not 50%*—Financial statements for the two most recent fiscal years, the latest interim period and the corresponding interim period of the preceding year are required.
- ▶ *Exceeds 50%*—Financial statements for full three years, the latest interim period and the corresponding interim period of the preceding year are required. However, financial statements for the earliest of the three fiscal years may be omitted if net revenues of the acquired business in its most recent fiscal year are less than \$50 million.
- ▶ *Exceeds 50% for multiple sub-20% acquisitions*—If no single acquisition exceeds 20% significance, but if the aggregate impact of the individually insignificant businesses acquired since the end of the fiscal year covered by the acquiror’s latest 10-K on file exceeds 50%, then financials for at least the *substantial majority* of sub-20% acquisitions must be filed. The financial statements must be for the most recent fiscal year and the latest interim period, and the corresponding interim period of the preceding year.

Exception – Notwithstanding all of the above, acquired company financial statements do not have to be included in the acquiror’s registration statement or proxy if the acquired business is below the 50% significance level *and* one of the following applies:

- The acquisition has not been consummated; or
- The final prospectus is dated, or the proxy is mailed, *within 74 days* after the consummation of the acquisition, *and* the acquired company financials have not already been filed by the acquiror (e.g., on Form 8-K).

Form 8-K

An acquiror generally must report an acquisition on Form 8-K as follows:

- ▶ *Notice filing within 4 business days after consummation of the acquisition* – The acquiror must file a Form 8-K describing an acquisition if it is (1) a business and it exceeds the 20% significance level or (2) an asset purchase that does not meet the definition of a business and the acquiror’s equity in the assets exceeds 10% of the acquiror’s consolidated assets.
- ▶ *Financials within 71 calendar days after the notice was due* – If financial statements for an acquired business are not provided with the notice filing, they must be filed by amendment within 71 days after the notice filing was due. The financials that must be filed are the same as those described above under “Registration Statements and Proxies of Acquiror.”

Determining ‘Significance’

The basic tests of significance are:

1. *Investment test*:

If *purchase accounting* applies, compare total GAAP purchase price of acquired entity to acquiror’s consolidated assets as of the end of the most recently completed fiscal year:

- “Investment” means total consideration, including any assumed debt for which the acquiror is the legal obligor, and costs of acquisition that will be allocated to assets and liabilities acquired.
- Include contingent consideration as part of the total investment in the target unless the likelihood of its payment is remote.

If *pooling or reorganization accounting* applies, compare:

- The net book value of the acquired entity’s assets to the acquiror’s consolidated assets as of the end of the most recently completed fiscal year; and
- The number of shares exchanged to the acquiror’s outstanding shares at the date the combination is initiated.

2. *Asset test*:

Compare acquiror’s share of acquired entity’s total assets to the acquiror’s consolidated assets as of the end of the most recently completed fiscal year.

3. *Income test*:

Compare acquiror’s equity in the acquired entity’s income from continuing operations before taxes, extraordinary items and cumulative effect of a change in accounting principle to that of the acquiror for the most recently completed fiscal year (and if the acquired business had a loss, then use the absolute value (not the negative number)).

Note: The acquired business is not considered part of (i.e., is not added to) the acquiror’s base in determining significance.

Definition of a ‘Business’

A business, for the purpose of Rule 3-05, is identified by evaluating whether there is sufficient continuity of operations so that disclosure of prior financial information is material to an understanding of future operations. There is a presumption that a separate entity, subsidiary or division is a business.

A lesser component, such as a product line, may also be considered a business depending on the facts and circumstances.

Definition of a ‘Group of Related Businesses’

Acquisitions of related businesses that are probable or that have occurred after the end of the latest fiscal year for which the acquiror’s 10-K is on file are treated as a single business combination under Rule 3-05. Businesses are deemed to be related if:

- ▶ They are under common control or management;
- ▶ The acquisition of one business is conditioned on the acquisition of the other businesses; or
- ▶ Each acquisition is conditioned on a single common event.

Pro Forma Financial Information

Article 11 of Regulation S-X requires the acquiror to provide pro forma financial information for the acquisition of a business that is at least 20% significant if such acquisition occurred in the latest fiscal year or subsequent interim period, or if such acquisition is probable. The following pro forma financial information is required:

- ▶ *Pro forma condensed balance sheet* – should be based on the latest balance sheet included in the filing and pro forma adjustments should be computed assuming the transaction was consummated on the balance sheet date.

The adjustments should give effect to events that:

- Are *directly attributable* to the acquisition; and
- Are *factually supportable*.

- ▶ *Pro forma condensed income statement* – pro forma presentation should be based on the latest year and interim period included in the filing.

The adjustments should give effect to events that:

- Are *directly attributable* to the acquisition;
- Are *factually supportable*; and
- Have a *continuing impact* only.

A pro forma income statement should not be presented for more than one complete fiscal year, unless the pro forma information gives effect to:

- ▶ A business combination to be accounted for as a pooling of interests or a reorganization of entities under common control; or
- ▶ Discontinued operations that are not yet required to be reflected in a historical statement.

Pro forma financial information required by Article 11 of Regulation S-X should be filed at the same time the audited financial statements of the target are filed. Additional pro forma information may also be appropriate if the target consummated a significant business combination of its own during the year, if that transaction would be material to an understanding of the acquiror or a vote on a transaction.

Using Securities of the Acquiror as Consideration

If securities to be offered to the security holders of the business to be acquired are being registered on Form S-4, when (x) the target is a reporting company in the U.S. (whether or not the acquiror's shareholders are voting) or (y) the target is a non-reporting company in the U.S. and the acquiror's shareholders are voting, the registration statement on Form S-4 must include the following financial statements of the target:

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

If securities to be offered to the security holders of the business to be acquired are being registered on Form S-4, when the target is a non-reporting company in the U.S. and the acquiror's shareholders are not voting, the requirement to include financials in the registration statement on Form S-4 is determined by the acquisition's level of significance. If the significance of the acquired business to the registrant:

- ▶ *Does not exceed 20%*—No financial statements are required (subject to continued monitoring of sub-20% acquisitions in the aggregate, and the inclusion of financials for a majority when 50% significance is reached, as discussed above).
- ▶ *Exceeds 20%*—GAAP financial statements for the most recently completed fiscal year and interim period are required. In addition, if the acquired business has provided GAAP financial statements for either or both of the two fiscal years before the latest fiscal year, the financial statements for those years are required.

Pro forma financial information depicting the acquisition is also required if the acquisition is significant under Rule 3-05 individually or in the aggregate, as discussed above.

Note: The requirement to audit the target financial statements in a Form S-4 depends on whether the Form S-4 is to be used for resales by persons considered underwriters.

Acquiring Less Than All of an Entity

According to the SEC's Division of Corporation Finance *Financial Reporting Manual* (2011 Edition), the acquisition of selected parts of an entity may result in less than full financial statements.

- ▶ In some circumstances, an acquiror does not acquire or succeed to all of the assets and liabilities of another entity. If the acquiror acquires or succeeds to substantially all of the entity's key operating assets, complete audited financial statements of the acquired entity will usually be required. Elimination of specified assets and liabilities not acquired or assumed by the acquiror is depicted in pro forma financial statements representing the effects of the acquisition.
- ▶ In other circumstances, the selling entity will retain significant operating assets, or significant operating assets that comprised the seller will continue to be operated by an entity other than the acquiror. Financial statements of the larger entity of which the acquired business was a part may not be informative. In that case, audited financial statements usually should be presented for the acquired component business, excluding the continued operations retained by the larger entity.
- ▶ The Staff of the SEC may accept audited statements of assets acquired and liabilities assumed and statements of revenues and direct expenses if it is impracticable to prepare the full financial statements required by Regulation S-X, and explanation of that impracticability is included in the filing.

► It is an SEC Staff practice that when “carve out” financial statements or statements of revenues and direct expenses are presented instead of full financial statements, full statements of cash flows are generally not required. “Carve out” financial statements should reflect all assets and liabilities of the acquired business even if they are not ac-

quired or assumed as part of the acquisition. However, the SEC Staff has required acquirers to provide information about the business’ operating, investing and financing cash flows, to the extent practicable, in the notes to the financial statements or in unaudited supplemental disclosure.