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Public Company's Financial Reporting Requirement Relating to Acquisitions

The U.S. Securities and Exchange Commission (the "SEC") believes that it is in the public interest for companies ("U.S. Public Companies") with reporting obligations under the Securities Exchange Act of 1934, as amended (the "1934 Act"), that undertake material acquisitions to disclose those acquisitions to the public. The information to be disclosed would include, among other matters, a description of the business being acquired and the terms of the acquisition. Such requirements could be triggered by a significant acquisition of a company or part of business of a company. Depending on how "significant" the material acquisition is, the SEC may require that certain additional financial information, including audited financial statements, for the company or business being acquired be provided to the public so that it can make an informed investment decision. Rule 3-05 of Regulation S-X sets out which acquisitions trigger disclosure on the financial information for the company or business being acquired and, if triggered, when that financial information is required to be filed. This requirement applies to significant acquisitions accomplished by both domestic issuers and foreign private issuers.

Part I of this summary covers specific requirements for financial statements required for registration statements and current event report filings. Part II covers types of acquisitions that trigger target company financials requirement. Part III covers when financial information of an acquired business financials must be included in public company filings. Part IV covers certain exceptions where regular rules do not apply in special situations.

I. Specific Requirements regarding Financials Furnished by the Acquiring Company.

In every case where target financial statements are required in the company's prospectus, the company will need to include pro forma financial information. If the acquiror has provided target company's financial information in previously filed 8-K amendment, previously filed financial statements may need to be updated for another fiscal quarter, or even for a full audited fiscal year. Age requirements are tested as of the effective date of the registration statement, rather than as of the filing date of the closing 8-K. Where historical financial statements of the target are required, pro forma financial information complying with S-X Article 11 must also be included. 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 acquiror is required, unless the transaction is already reflected in that balance sheet.
- A condensed pro forma income statement: For the acquiror's most recently completed fiscal year and the most recent stub period of the acquiror, unless the historical income statement reflects the transaction for the entire period.

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[1] US-based public companies are required to include target company's financials in the issuer's current event report (Form 8-K) regarding the acquisition. A foreign private issuer is required to provide such financial statements in current event report, or form 6-K.

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II. Types of Acquisitions that Trigger Target Company Financial Information

If an acquisition or a series of aggregated acquisitions is deemed as "significant", it will trigger the requirement for audited financial statements for the target company.

(1) Significance Test.

An individual acquisition (or multiple acquisitions of related businesses) is "significant" if the acquiror trips *any* of the following three tests above the 20% level:

- **Investment test:** The amount of the acquiror's investment in the target compared to the acquiror's total assets;
- **Total asset test:** The total assets of the target compared to the acquiror's total assets; or
- **Pre-tax income test:** The target's income from continuing operations before income taxes, extraordinary items and cumulative effect of a change in accounting principles ("pre-tax income") compared to the pretax income of the acquiror for its most recent full fiscal year. If either the acquiror or the target had a net loss, then the absolute value of the negative amount is used for this test.

(2) Requirements if "significant"

If individual acquisition (or multiple acquisitions of related businesses) is not significant based on the tests set forth above, then no audited financial statements are required for the target.

If individual acquisition (or multiple acquisitions of related businesses) exceeds 20% significance but not 40% significance, the acquiror must include audited financial statements for the most recent fiscal year of the target. Unaudited interim financial statements for any stub period may also be needed, subject to staleness rules.

If individual acquisition (or multiple acquisitions of related businesses) exceeds 40% but not 50% significance, the acquiror will need to include audited financial statements for the two most recent fiscal years of the target. Unaudited interim financial statements for any stub period may also be needed, subject to staleness rules.

(3) "Probable" Acquisition with Greater than 50% Significance

For acquisitions above the 50% significance level, financial statements for the three most recent fiscal years of the target will be required even if the transaction has not closed yet so long as the transaction is "probable". If individual acquisition (or multiple acquisitions of related businesses) has greater than 50% significance and is probable, the acquiror will generally need to include audited financial statements for the three most recent fiscal years of the target. Among other exemptions, U.S. Public Companies that are foreign private

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issuers undertaking acquisitions of 50% or greater will only need to provide two years of financial statements if they are filing a registration statement in connection with a public offering.

Rule 3-05 does not define "probable" acquisition, as it is a fact-specific inquiry taking account of issuer-specific considerations SEC has provided guidance in multiple occasions regarding what "probable" means. For example, SEC Financial Reporting Manual states that "Assessment of 'probability' requires consideration of all available facts. Acquisition is probable where registrant's financial statements alone would not provide adequate financial information to make an investment decision." From practice view, the following factors should be considered in assessing whether an acquisition is "probable" for purpose of the registrant's reporting duty:

- Whether there is signed definitive agreement or letter of intent;
- Whether the approval from the board of directors of shareholders of the companies exists;
- whether there is submission of the terms of the proposed transaction to the regulatory agency for approval;
- overall status of negotiations;
- whether any financial penalty is in place if the acquisition is not consummated;
- whether the acquiror or the target company have made public announcement regarding the business acquisition.

Note that the above list is non-exhaustive, and an acquisition may still be considered "probable" when none of the above factors exist, as long as the acquiror's financial statements alone would not provide investors with adequate information for investment decision making. The registration bears the responsibility to assess probability. Such assessment is fact intensive and industry specific, and advice from SEC legal counsel should be considered.

Lastly, in the case where multiple acquisitions of unrelated businesses that are less than 20% significant individually, are more than 50% significant on a combined basis, the acquiror will need to include the required financial information for the most recent fiscal year for a majority of the acquisitions even if they are individually insignificant (i.e. below the 20% significance level). Unaudited interim financial statements for any stub period may also be needed, subject to staleness rules. For this purpose, an acquisition is aggregated with any acquisitions that do not exceed 20% significance but closed after the date of the most recent audited balance sheet and any acquisitions that are only probable or which only closed during the past 74 days. If financial statements are required due to this aggregation, they need to cover at least one fiscal year (and latest interim period) for a majority of the targets, calculated based on significance.

III. When Audited Financial Statements of a Target Must Be Included in the Filings

A U.S. Public Company may have to include audited financial statements in connection with a significant acquisition in a current report on Form 8-K or in a registration statement. If a company is not yet a U.S. Public Company but it has filed a registration statement with the SEC, it may have to include audited financial statements in connection with a significant acquisition in that registration statement before the SEC will declare it effective.

1. *Required Financial Information on Form 8-K*

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A significant acquisition by a U.S. public company triggers an 8-K at three different points: (1) when the acquisition agreement is signed, (2) when the acquisition closes and (3) within approximately 75 days of

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closing to file required target and pro forma financial statements, unless they were previously filed in a registration or proxy statement. When filing the 8-K/A, the permitted age of the financial statements is determined by reference to the filing date of the closing 8-K.

(1) "Signing" 8K: When a U.S. Public Company signs a definitive agreement to enter into a significant acquisition, it must file an 8-K within four business days disclosing entry into that material agreement and provide certain related information. The U.S. Public Company does not need to include the audited financial information regarding the business to be acquired in this 8-K, but may include such financial information on voluntary basis[2].

(2) Closing 8K: U.S. Public Companies must disclose that a significant acquisition has closed within four business days of such a closing. The U.S. Public Company does not need to include the audited financial information regarding the business that was acquired in this 8-K, but may include such financial information on voluntary basis.

(3) 8K/A: Unless previously filed with the SEC, U.S. Public Companies must file audited financial information regarding the business that was acquired in an amendment to the 8-K that was filed at closing within 71 days of the due date of such initial 8-K, or 75 days of the execution date of the transaction.

2. *Required Financial Information in a Registration Statement*

U.S. Public Companies must include the Required Financial Information in a registration statement:

- for an acquisition that has occurred and the significance of which is between 20% and 50%, if such acquisition occurred 75 days before the effectiveness of such registration statement;

- for an acquisition that has occurred and the significance of which is 50% or greater, in such registration statement regardless of how much time has passed since the acquisition occurred;

- for an acquisition that has not yet occurred but which is "probable" and the significance of which is 50% or greater, in such registration statement;

- for an acquisition that has not yet occurred but which is "probable" and the significance of which is between 20% and 50%, in certain situations where the acquiring company's financial statements alone would not provide investors with adequate financial information (this is a fact-specific inquiry taking account of issuer-specific considerations).

IV. Certain Exceptions

[2] If the acquisition does not involve a business or if it is not considered significant because it does not exceed 20% on any of the three tests it may still trigger a closing 8-K if the acquiring company's equity in the net book value of the assets acquired or the amount paid exceed 10% of the acquiring company's total assets.

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Special situations exist where financial information requirement differs from what is set out above. For examples:

- Emerging growth company IPOs: EGCs are not required to present more than two years of target's audited financial statements in an IPO filing, even if presenting three years of acquiror audited financials.

- Using pro forma financials of the acquiror: A serial acquirer[3] may be able to use pro forma financials that are more recent than its most recent audited financials for purposes of calculating significance in certain circumstances. This can be useful where the pro forma information produces a larger "denominator" for testing significance.

- Shelf takedowns: The rules for shelf takedowns are generally the same as those for new registration statements. However, in certain circumstances, such as a purely secondary offering, it is possible to conduct an offering using an existing shelf without providing historical financial statements for probable acquisitions that exceed the 50% significance level.

- Acquisitions of related businesses: Related businesses are treated as a single business when measuring significance. If significance under S-X Rule 3-05 is met, separate financial statements for each of the related businesses (or combined financial statements, if appropriate under GAAP) will be required.

- Acquisitions of Oil and Gas Properties: Producing oil and natural gas properties are considered to be a business under Rule S-X 11-01(d). If the acquired property represents less than substantially all of the selling entity's key operating assets, abbreviated audited financial statements may be provided in the form of a statement of revenues and direct operating expenses

Understanding the SEC rules and market practice for financial statements triggered by significant acquisitions is crucial for planning and executing capital markets transactions. It is also important for negotiating acquisitions and related financing commitments. If the acquiring company wants to access the capital markets, or draw on a bridge financing, to finance the acquisition it may need target and pro forma financial statements much sooner than would be required by the SEC. As this memorandum is a summary of a complex subject matter, and the SEC's interpretation of it could still be evolving, you are encouraged seek further guidance from your advisors to plan for your next acquisition.

[3] Serial acquirers are firms which engage in streams of acquisitions to execute their strategies for enhanced value or performance. (*See Customer retention: A source of value for serial acquirers, William Y. Degbey*, *Industrial Marketing Management Volume 46, April 2015, Page 11-23*.)