

REIT Alert: SEC Updates Financial Disclosures about Acquisitions and Dispositions of Businesses, Including Real Estate Operations

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Earlier this year, the Securities and Exchange Commission updated its requirements to provide financial information about acquisitions and dispositions of businesses and real estate operations, the first time that these requirements had been comprehensively addressed in over 30 years. The amendments impact disclosure in current reports under Form 8-K, which are filed by reporting companies, as well as disclosure in certain transaction filings (registration statements, proxy statements and prospectuses).

In addition to changes to the content and presentation of financial disclosure under Regulation S-X, the amendments are intended to raise the threshold when determining whether acquisitions and dispositions are significant for purposes of triggering financial disclosure. The amendments – of particular interest to real estate investment trusts (“REITs”) – clarify that the investment test under Rule 1-02(w) is to be used to measure the significance of transactions in real estate operations. The amendments also more closely align the financial disclosure requirements for acquisitions of real estate operations under Rule 3-14 with those applicable to acquisitions of other businesses under Rule 3-05.

The amendments will be effective on January 1, 2021, but voluntary compliance is permitted in advance of the effective date as long the registrant complies with the amendments in their entirety.

Background

As the Commission explains in the press release accompanying the final amendments, when a registrant acquires a significant business, other than a real estate operation, Rule 3-05 of Regulation S-X generally requires a registrant to provide separate audited annual and unaudited interim pre-acquisition financial statements of that business. The number of years of financial information that must be provided depends on the relative

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significance of the acquisition to the registrant.

Rule 3-14 of Regulation S-X addresses the unique nature of real estate operations and requires a registrant that has acquired a significant real estate operation to file financial statements with respect to such acquired operation.

In addition to the historical financial statements required under Rule 3-05 or 3-14, Article 11 of Regulation S-X requires registrants to file unaudited pro forma financial information relating to the acquisition or disposition. Pro forma financial information typically includes a pro forma balance sheet and pro forma income statements based on the historical financial statements of the registrant and the acquired or disposed business, including adjustments to show how the acquisition or disposition might have affected those financial statements.

Changes to Significance Tests for Acquisitions and Dispositions

The significance of an acquisition or disposition is measured using the investment, asset and income tests under the “significant subsidiary” definition in Rule 1-02(w) of Regulation S-X, Securities Act Rule 405 and Securities Exchange Act Rule 12b-2. The amendments revise the investment test and the income test, but no substantive revisions were made to the asset test. Furthermore, the amendments clarify that only the investment test should be used for real estate operations.

The amendments, among other things, update the significance tests by:

- increasing the significance threshold for dispositions from 10% to 20%, so that it is equal to the threshold for acquisitions;
- revising the investment test to compare the registrant’s investments in and advances to the acquired or disposed business or real estate operation to the registrant’s aggregate worldwide market value if available; in the absence of an aggregate worldwide market value, investments may continue to be compared to a registrant’s total assets;
- revising the income test by adding a revenue component, so that a business is only significant if it exceeds an income threshold as well as a revenue threshold; and
- expanding the use of pro forma financial information in measuring significance, if the registrant has previously completed a significant acquisition after its last fiscal year and has filed historical and pro forma financial statements on a current report on Form 8-K.

The amendments also modify and enhance the required disclosure for the aggregate effect of acquisitions for which financial statements are not required or are not yet required by:

- eliminating historical financial statements for insignificant businesses and real estate operations; and
- expanding the pro forma financial information to depict the aggregate effect of the acquisitions in all material respects.

In terms of periods to be presented, the amendments require the financial statements of the acquired business to cover no more than the two most recent fiscal years, though three years of historical financial statements for a target company still could be required in a transaction subject to a shareholder vote.

Changes Specific to Real Estate Operations

Certain amendments that specifically affect real estate operations are summarized below. Where they are referenced, “Rule 3-14 Financial Statements” refer to separate audited annual and unaudited interim abbreviated income statements with respect to such real estate operations.

Topic	Old Rule	New Rule
Definition of “Real Estate Operation”	The Commission staff interpreted a “real estate operation” to refer to properties that generate revenues solely through leasing, but did not interpret this definition to preclude a property that included a limited amount of non-leasing revenues (like property management or other services related to the leasing).	“Real estate operation” is defined as “a business that generates substantially all of its revenues through the leasing of real property,” with the term “substantially” being dependent on the specific facts and circumstances. The amendments clarify that a real estate operation is a “business” as that term is used in Article 11 for purposes of pro forma financial disclosure.
Significance Determination	The significance threshold for individual acquisitions and dispositions is the 10 percent significance threshold in Rule 1-02(w). Due to the nature of a real estate operation, staff interpretations have sought to focus registrants on the investment test in Rule 1-02(w), adapted to compare the registrant’s and its other subsidiaries’ “investments in” the real	The significance threshold for individual acquisitions and dispositions of real estate operations aligns with the 20 percent threshold for businesses in Rule 3-05. New Rule 3-14(b)(2) requires the use of the investment test in Rule 1-02(w) to determine the significance of the acquisition or disposition of a real estate operation.

	estate operation, including any debt secured by the real properties that is assumed by the registrant, to the registrant's total assets at the last audited fiscal year end when determining "significance" under Rule 3-14.	The new rule requires a registrant to compare its (and its other subsidiaries') investments in and advances to the tested subsidiary to the aggregate worldwide market value of the registrant's voting and non-voting common equity, when available. If the registrant's significance test is based on total assets (vs aggregate worldwide market value), consistent with the old rule, the test should be adapted to compare the registrant's and its other subsidiaries' "investments in" the real estate operation, including any debt secured by the real properties that is assumed by the registrant, to the registrant's total assets as of the end of the most recently completed fiscal year. The significance test for blind pool offerings by non-traded REITs is codified to compare the registrant's and its other subsidiaries' "investments in" the real estate operation to the sum of: (1) The registrant's total assets as of the date of the acquisition, and (2) The proceeds (net of commissions) in good faith expected to be raised in the registered offering over the next 12 months.
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Aggregate Effect of Insignificant Acquisitions	Registrants must aggregate consummated and probable acquisitions since the date of the most recent audited balance sheet that are less than 10 percent significant, and if the significance of the aggregated group exceeds 10 percent, Rule 3-14 Financial Statements are provided for each acquisition that is 5 percent or more significant and for enough other acquisitions in order to cover the substantial majority of the group.	Registrants must aggregate consummated and probable acquisitions since the date of the most recent audited balance sheet that are less than 20 percent significant, and if the significance of the aggregated group exceeds 50 percent: • No historical financial information is required for any acquisitions that do not exceed the 20 percent significance threshold. • Pro forma financial information that depicts the aggregate impact of acquired or to be acquired real estate operations in all material respects is required.¹ • Financial statements covering at least the most recent fiscal year and the most recent interim period for any acquired or to be acquired real estate operation for which financial statements are not yet required based on Rule 3-14(b)(3)(i) for certain registration statements and proxy statements.
Related Party Acquisitions	Registrants must provide three years of financial statements for significant acquisitions from related parties.	The new Rule 3-14 eliminates the specific requirement to provide three years of financial statements for acquisitions from related parties. Like Rule 3-05, it does not differentiate the number of periods for which historical financial statements are required based on whether

		the seller is a related party or not.
Financial Statements Covering 9 to 12 months	Existing Rule 3-06(b) provides that financial statements required under Rule 3-05 “covering a period of 9 to 12 months shall be deemed to satisfy a requirement for filing financial statements for a period of 1 year,” but it did not address acquired real estate operations under Rule 3-14.	Rule 3-06(b) is revised explicitly to permit the filing of financial statements covering a period of 9 to 12 months to satisfy the requirement for filing financial statements for a period of 1 year for an acquired or to be acquired real estate operation.
Timing of Filings		New Rule 3-14 includes the same period for the filing of Rule 3-14 Financial Statements in registration statements and proxy statements as exists under Rule 3-05.
Omission of Financial Statements		New Rule 3-14 is aligned with new Rule 3-05 to no longer require Rule 3-14 Financial Statements in registration statements and proxy statements once the acquired real estate operation is reflected in filed post-acquisition registrant financial statements for nine months.
Interim Financial Statements	Rule 3-14 does not include an express requirement for registrants to provide interim financial statements. However, existing registrant practice is to provide interim financial statements for acquisitions of real estate	Rule 3-14 Financial Statements are specifically required for the most recent year-to-date interim period prior to the acquisition.

	operations.	
Auditor Independence	Auditors of Rule 3-14 Financial Statements need not be independent.	Auditors of Rule 3-14 Financial Statements are subject to applicable independence standards.
Triple Net Leases	In some circumstances, registrants acquire a real estate operation subject to a triple net lease with a single lessee. A triple net lease typically requires the lessee to pay costs normally associated with ownership of the property, such as property taxes, insurance, utilities, and maintenance costs. Under existing practice, registrants often provide audited financial statements of the lessee or guarantor of the lease, instead of the Rule 3-14 Financial Statements of the real estate operation, when the lessee is considered significant.	The amendments do not differentiate this type of acquisition or specify alternatives to Rule 3-14 for this type of acquisition, because the activity depicted in the Rule 3-14 Financial Statements is consistent with how the triple net lease arrangement may affect the registrant's results of operations.

The amendments also update current reports on Form 8-K, with more specific requirements on acquisitions and dispositions of real estate operations. The amendments:

- Clarify that Item 2.01 requires the disclosure of the acquisition or disposition of assets that constitute a significant real estate operation as defined in Rule 3-14;
- Address the financial statement filing requirements in Item 9.01(a) consistently for all business acquisitions, including real estate operations; and
- Revise Item 2.01 Instruction 4 to make clear that the aggregate impact of acquisitions of real estate operations is not required to be reported unless these acquisitions are related real estate operations and are significant in the aggregate.

We expect that the foregoing amendments will result in additional staff guidance as well as substantial revisions to the Commission's Financial Reporting Manual, including

sections of the Manual that address real estate operations.

¹ The Commission notes that, in some circumstances, accountants might need to perform additional work to meet the “reasonable investigation” and “reasonable care” due diligence standards of the Securities Act in order to provide negative assurance to underwriters on the combined pro forma financial information.