

Technical Line

SEC – final rule

How to apply the amended S-X Rule 3-14 to real estate acquisitions

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What you need to know

- ▶ The SEC has amended Rule 3-14 of Regulation S-X to align it with the guidance in Rule 3-05, including the amendments to Rule 3-05 made at the same time.
- ▶ Key changes include increasing the significance threshold to 20% from 10%, requiring the use of a registrant's worldwide market value instead of total assets in the calculation when it is available and increasing the aggregate significance threshold for individually insignificant acquisitions to 50% from 10%.
- ▶ The amendments also codify SEC staff guidance that companies have been applying.
- ▶ The determination of whether an acquired property qualifies as a real estate operation is essential to the application of Rule 3-14 and often requires judgment by management.
- ▶ Companies contemplating acquisitions of real estate or forming a REIT need to understand the requirements of amended Rule 3-14.
- ▶ The amendments are effective on the first day of an annual period that begins after 31 December 2020 (e.g., 1 January 2021 for a calendar year-end company). Earlier compliance is permitted.

Overview

Rule 3-14 of Regulation S-X, *Special instructions for financial statements of real estate operations acquired or to be acquired*, requires registrants to present the audited financial statements of significant consummated and probable acquisitions of real estate operations. The financial statements required by Rule 3-14 must be accompanied by pro forma financial information (pro formas) presented in accordance with Article 11 of Regulation S-X.

The Securities and Exchange Commission (SEC) has **amended** Rule 3-14 to further align it with the requirements for significant business acquisitions in Rule 3-05, *Financial statements of businesses acquired or to be acquired*,¹ which it amended at the same time.

Key changes to Rule 3-14 include:

- ▶ Increasing the individual significance threshold to 20% from the 10% that has been applied in practice
- ▶ Revising the significance test to compare the fair value of the consideration transferred to an average aggregate worldwide market value of the registrant's voting and non-voting common equity (WWMV), when available, but continuing to require the use of total assets when WWMV isn't available
- ▶ Increasing the aggregate significance threshold for individually insignificant acquisitions to 50% from 10%
- ▶ Reducing the periods required in audited financial statements from three years to one year when a significant real estate operation is acquired from a related party
- ▶ Allowing registrants to file Rule 3-14 financial statements that cover a nine-month period instead of a full year
- ▶ Allowing a 74-day grace period after consummation of certain acquisitions before Rule 3-14 financial statements must be included in registration and proxy statements
- ▶ Eliminating the special treatment required under the legacy rules for acquisitions of properties subject to triple net leases²

Refer to Appendix B for a more detailed comparison of amended Rule 3-14 to the legacy rule and to Appendix C for a comparison of amended Rules 3-14 and 3-05.

The amendments also codify most of the SEC staff's interpretive guidance that entities have previously applied, though some of the SEC staff guidance remains outside of the rule and has not been updated.

This Technical Line, which updates our earlier publication, provides information to help registrants apply Rule 3-14. Specifically, we discuss evaluating whether a property qualifies as a real estate operation, measuring significance and determining the financial statement and pro forma requirements. We also discuss the following types of transactions covered by Rule 3-14 and the SEC staff guidance for applying Rule 3-14:

- ▶ Real estate investment trust (REIT) formation transactions
- ▶ "Blind pool" offerings
- ▶ Properties securing mortgage loans that represent a significant asset concentration

Pro formas accompany Rule 3-14 financial statements of acquired real estate operations and must comply with the requirements of Article 11 of Regulation S-X, which was also amended. Please refer to our Technical Line, ***Applying the SEC's new requirements for significant acquired businesses***, for a discussion of these requirements. Registrants may also refer to chapters 2 (Rule 3-14) and 3 (Article 11) of the SEC's Division of Corporation Finance Financial Reporting Manual,³ but they should confirm the relevance of any guidance that is labeled as updated before 21 May 2020, when the SEC adopted the new rules.

Definition of a real estate operation

Rule 3-14 defines a real estate operation as a business that generates substantially all of its revenue through the leasing of real property. Whether the rule applies to a property depends on an evaluation of its rental history.

The SEC staff has said that it is not necessary to apply Rule 3-14 to a property that has less than three months of history (e.g., newly constructed properties, previously owner-occupied properties). The SEC staff has also said that a registrant can omit the financial statements of a property that will be demolished and replaced with a new rental property, regardless of its rental history. However, the registrant should explain the basis for omission of the financial statements within the relevant filing.

How we see it

A registrant that believes separate financial statements of an acquired property will not be useful to investors because its leasing history does not reflect its future utilization should contact the SEC staff to discuss potential relief under S-X Rule 3-13.

The use of the term “substantially all” in the definition of a real estate operation indicates that there is no bright line, and the application of the rule depends on the facts and circumstances. Acquisitions of commercial real estate, such as office or industrial buildings, apartment complexes and shopping centers, generally meet the definition of a real estate operation. Properties such as nursing homes, hotels, golf courses and auto dealerships generally do not meet the definition of a real estate operation because leasing doesn’t drive substantially all of their revenues. A registrant that acquires one of these properties generally applies Rule 3-05, which has additional significance requirements and requires more robust financial statements.

If a real estate operation is not being leased at acquisition but has a leasing history and is expected to generate lease revenue in the near future, the registrant could still conclude that it is a business that generates substantially all of its revenues through the leasing of real property.

The evaluation of whether Rule 3-14 or Rule 3-05 applies is separate and distinct from the determination under US GAAP of whether a business has been acquired in accordance with Accounting Standards Codification (ASC) 805, *Business Combinations*.

Illustration 1 – Evaluating real estate operations

Scenario 1 – Senior residential living community

Company Y acquires a senior residential living community where residents live independently and require limited care by the staff. The property leases space to an outside party that provides on-site medical services. The facility also operates a cafe where residents and visitors can purchase meals, snacks, beverages and sundry items. In the fiscal year before the acquisition, the community generated \$5 million in rental revenues from residents and the outside party in the fiscal year before the acquisition. The community also generated \$0.5 million in revenue from the sale of items at the cafe.

Analysis: The senior residential living community likely meets the definition of a real estate operation since the property generates substantially all of its revenue from the leasing of real property. Company Y could reach a different conclusion if the residential living community itself generated revenues by providing medical services in addition to leasing and the cafe.

Scenario 2 – Senior assisted-living facility

Company Z acquires a senior assisted-living facility where all residents require regular care and assistance and are unable to prepare their own meals. The facility employs a team of in-house medical personnel and delivers three meals per day to residents. The facility generated \$3 million in rental revenue from residents, \$2 million in medical billings and \$1 million from food service in the fiscal year before the acquisition.

Analysis: The facility did not generate substantially all of its revenue from the leasing of real property. Therefore, the registrant would apply Rule 3-05 to this acquisition and provide full audited financial statements if the applicable significance thresholds are met.

Registrants must also apply Rule 3-14 if they acquire an equity interest in an existing or newly formed legal entity (e.g., a partnership, corporation, limited liability company) that will acquire properties under lease and the related mortgage debt in connection with, or soon after, the entity's formation. If the acquired entity engages in operations in addition to leasing, the registrant must consider whether the "substantially all" criterion is met and apply Rule 3-05 if it is not.

How we see it

Many operators of real estate assets seek to maximize the cash flows of a property by identifying and expanding ancillary sources of revenue. Although the determination of whether an acquisition meets the definition of a real estate operation may initially appear to be straightforward, registrants must carefully evaluate all revenue sources to determine whether they are acquiring real estate operations, in which case Rule 3-14 would apply, or a business, in which case Rule 3-05 generally would apply.

The significance threshold in amended Rule 3-14 is 20%.

Calculating significance

A registrant that determines that it has acquired a real estate operation is required to file Rule 3-14 financial statements and pro formas if the acquisition exceeds 20% significance. Rule 3-14 requires a registrant to calculate the significance of an acquisition using the investment test defined in Rule 1-02(w) of Regulation S-X.

A group of related properties must be evaluated together as if they were a single acquisition for purposes of the investment test. The test is performed as it is described below except the amounts are aggregated. If the aggregate result of the investment test exceeds 20%, Rule 3-14 financial statements and pro formas must be filed for each property.

Properties are deemed to be related if any of the following apply:

- The properties are under common control or management.
- The acquisition of one real estate operation is conditioned on the acquisition of each of the other real estate operations.
- Each acquisition is conditioned on a single common event.

Investment test

The amended investment test compares the investments by the registrant and its other subsidiaries in the acquired property and any advances they make to the acquired property to the registrant's WWMV. The term "investments in the acquired property" refers to the fair value of the consideration transferred for a property, adjusted to exclude the carrying value of any assets transferred by the registrant to the acquired property that will remain with the registrant after the acquisition.

When an acquisition meets the definition of a business combination in ASC 805, transaction costs are excluded from the numerator because they are expensed as incurred under the accounting guidance. When an acquisition does not meet the definition of a business combination under ASC 805 (i.e., it is an asset acquisition), transaction costs are typically capitalized, and we expect companies to continue to include them in the numerator of the investment test, as they have done under the legacy rules.

The WWMV is calculated using the shares outstanding and daily average price of the registrant's common stock for the last five trading days of the calendar month ended before the earlier of the registrant's announcement of the transaction or the date of the acquisition agreement. The SEC staff has said that WWMV should not include preferred stock (even if it is convertible into common stock) or non-traded common shares that are exchangeable into traded common shares.

When WWMV is not available, a registrant should instead use the total assets from its most recent annual audited pre-acquisition financial statements required to be filed with the SEC. There are certain exceptions to this general rule described in more detail below.

A registrant that uses total assets as the denominator for the significance calculation also must include in the numerator any debt secured by the property that is assumed by the registrant.

Illustration 2 – Calculating significance

Company A, a calendar-year company, acquired a fully occupied office building on 30 June 20X1. Company A and the seller agreed to the transaction on 30 April 20X1 and announced the acquisition on 1 May 20X1. Company A paid cash consideration of \$15 million and assumed existing mortgage debt secured by the property of \$30 million. Company A's total assets at 31 December 20X0 were \$250 million.

Scenario 1 – Using WWMV

Assume that Company A is a registrant, and its WWMV was \$70 million, calculated based on the last five trading days of March 20X1 (i.e., the month ended before the date of the agreement). Because the acquisition is 21% significant ($\$15 \text{ million} \div \70 million), Company A must file Rule 3-14 financial statements and pro formas.

Scenario 2 – Using total assets

Assume that Company A is in process of conducting an initial public offering (IPO) and does not have WWMV. In this case, Company A uses total assets instead of WWMV as the denominator and includes the mortgage debt in the numerator ($\$45 \text{ million} \div \250 million). Significance is calculated as 18%, so Company A is not required to file Rule 3-14 financial statements or pro formas.

Exceptions when using total assets for the investment test

When using its total assets, a registrant generally measures significance using its pre-acquisition consolidated financial statements as of the end of the most recently completed audited fiscal year required to be filed with the SEC. However, the following exceptions apply:

- ▶ A registrant that has not completed its first full fiscal year of operations should use total assets from its most recent audited balance sheet on file with the SEC.
- ▶ A registrant that completes an acquisition after year end but before filing its Form 10-K may use total assets as of the end of that year if it files the Form 10-K before the due date of the Form 8-K/A that will include the Rule 3-14 financial statements and pro formas. In a registration statement, the registrant must use the total assets from its most recent audited financial statements on file as of the filing and effective dates.

- ▶ A registrant can use pro forma total assets if it previously filed pro forma financial information that gives effect to all the significant acquisitions and dispositions that occurred since year end. A registrant that elects to test using pro forma total assets must continue to do so until it files its next Form 10-K. This significance measurement exception is also extended to IPO transactions.

Refer to the section *When to present Rule 3-14 financial statements* below for further discussion on timing of filing Rule 3-14 financial statements and pro formas in a Form 8-K.

Illustration 3 – Completing an acquisition after fiscal year end

Company B, a calendar-year registrant, completes an acquisition of a fully leased distribution facility on 4 January 20X2 for a total investment, including assumed debt, of \$40 million. Company B's common equity is not publicly traded. Company B's total assets for the period ended 31 December 20X0 were \$190 million. Company B plans to file Form 10-K for the period ended 31 December 20X1 on 28 February 20X2 and will report total assets of \$210 million as of the balance sheet date.

Analysis: Because the acquisition is 21% significant ($\$40 \text{ million} \div \190 million), Company B must file an Item 2.01 Form 8-K by 8 January 20X2 (i.e., four business days after 4 January) and an Item 9.01 Form 8-K by 19 March 20X2 (i.e., 71 days after 8 January) with Rule 3-14 financial statements and pro formas.

If Company B files its 20X1 Form 10-K within the anticipated time frame, it may use total assets as of 31 December 20X1 to recalculate the significance of the acquired property and would no longer be required to provide Rule 3-14 financial statements and pro formas because the acquisition is only 19% significant ($\$40 \text{ million} \div \210 million).

Illustration 4 – Completing a subsequent acquisition after a significant acquisition

Company C, a calendar-year registrant, completed a significant acquisition on 15 February 20X2. Company C provided Rule 3-14 financial statements and pro formas for this acquisition on Form 8-K on 10 April 20X2. The pro forma financial information as of 31 December 20X1 reflected total assets of \$550 million. Company C acquires a fully leased retail center on 31 July 20X2 for a total investment of \$100 million (including assumed debt). Company C's common equity is not publicly traded. Company C's total assets as of 31 December 20X1 were \$475 million.

Analysis: Company C is permitted to evaluate the significance of the \$100 million acquisition on 31 July 20X2 using the pro forma total assets reported in the 10 April 20X2 Form 8-K filing. As a result, the acquisition is only 18% significant ($\$100 \text{ million} \div \550 million), and Company C would not be required to report this acquisition on Form 8-K.

Aggregation of individually insignificant properties for registration statements and proxy statements

When filing a registration statement or proxy statement, a registrant must also calculate the aggregate significance of acquisitions that do not individually trigger a requirement to include Rule 3-14 financial statements and pro formas. This calculation includes:

- ▶ Any acquisition consummated after the registrant's most recent audited balance sheet date whose significance does not exceed 20%
- ▶ Any probable acquisition whose significance does not exceed 50%

- ▶ Any consummated acquisition that is more than 20% significant but not more than 50% significant for which Rule 3-14 financial statements and pro formas are not yet required because the filing or effective date of the registration statement falls within 74 days of consummation

If the registrant is filing a registration statement or proxy statement and the aggregate result of the investment test for the individually insignificant properties exceeds 50%, the registrant must include:

- ▶ Pro forma financial information that depicts the aggregate impact of those acquired or to-be-acquired real estate operations in all material respects
- ▶ 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 that is more than 20% significant

Refer to the section *When to present Rule 3-14 financial statements* below for further discussion on timing of filing Rule 3-14 financial statements in connection with a registration statement.

If the registrant acquires both businesses subject to Rule 3-05 and real estate operations subject to Rule 3-14, the registrant must use the significance tests that apply to each type of transaction. When aggregating significance, the registrant must include both the businesses and the real estate operations. If the aggregate significance of the individually insignificant businesses and real estate operations exceeds 50%, the registrant must include pro formas that depict the aggregate impact of those acquired or to-be-acquired businesses and real estate operations in all material respects. For individually insignificant businesses or real estate operations that exceed 20% and are included in the aggregate significance test, the registrant would include the respective Rule 3-05 or Rule 3-14 financial statements.

Registrants that are unable to obtain audited financial information to comply with these requirements should contact the SEC staff to discuss potential relief under S-X Rule 3-13.

Individually insignificant properties must be evaluated for significance in the aggregate.

How we see it

Because the significance threshold for individually insignificant acquisitions was raised to 50% from 10%, registrants will need to provide financial statements and pro formas for these acquisitions far less frequently.

Illustration 5 – Evaluating individually insignificant properties

Company D, a calendar-year registrant, files a registration statement on 9 July 20X2 and incorporates by reference its 20X1 Form 10-K. The table below summarizes properties Company D acquired in 20X2 and acquisitions that are probable at the filing date:

20X2 year-to-date acquisitions		Probable acquisitions	
	Significance		Significance
Property A	22%	Property D	9%
Property B	2%	Property E	10%
Property C	15%	Property F	21%

Property A exceeded 20% significance. Company D has previously filed Rule 3-14 financial statements and pro formas in a Form 8-K that is incorporated by reference in the registration statement.

Analysis: Properties B and C are individually insignificant because neither exceeds 20%. Properties D, E and F are also individually insignificant because they have not occurred and are not more than 50% significant. The aggregate significance of these acquisitions totals 57%.

To comply with Rule 3-14, Company D must present pro forma financial information that depicts the aggregate impact of all of the properties in all material respects. Company D must also include Rule 3-14 financial statements for Property F because its significance is greater than 20%. Rule 3-14 financial statements for properties B, C, D and E are not required.

How we see it

- ▶ Because the requirement to provide pro formas that reflect individually insignificant acquisitions is qualified by materiality (i.e., in all material respects), we believe that a registrant can make judgments regarding which acquisitions to include. For example, Company D in Illustration 5 could conclude that including Property B is not necessary to show the material effects of all the transactions.
- ▶ Under the amended rules, registrants may file more pro formas that include financial information of properties that have not had their historical financial statements audited or reviewed than they have in the past. In these cases, a registrant should work closely with its auditor to determine what additional procedures the auditor may need to perform to provide negative assurance on the pro formas in a comfort letter.

Financial statement requirements

When to present Rule 3-14 financial statements

Rule 3-14 financial statements and pro formas must be filed on Form 8-K and in certain Securities Act registration statements as described below.

Form 8-K

A registrant must report the acquisition of a significant real estate operation (i.e., completed acquisition that exceeds 20% significance) under Item 2.01, *Completion of Acquisition or Disposition of Assets*, of Form 8-K by the fourth business day after consummation. It also must file Rule 3-14 financial statements and pro formas under Item 9.01, *Financial Statements and Exhibits*, of Form 8-K by the 71st calendar day (or next business day if it occurs on a weekend or holiday) after the Item 2.01 due date.

General instruction A of Form 8-K allows a registrant to skip filing an Item 9.01 Form 8-K containing Rule 3-14 financial statements and pro formas if the registrant already included the information in a registration statement and the information in the Form 8-K would be “substantially the same” as what is presented in that registration statement. This instruction generally allows registrants to skip filing an Item 9.01 Form 8-K if the Rule 3-14 financial statements it would need to provide in the Form 8-K would need only one additional interim quarter based on the financial statement age requirements discussed below. However, registrants will need to file an Item 9.01 Form 8-K if they previously filed third-quarter financial information of an acquired real estate operation and the Form 8-K requires audited financial statements for the latest annual period.

Registration statements

Registrants are required to include Rule 3-14 financial statements and pro formas in the following filings for acquired real estate operations and probable acquisitions that are significant individually or in the aggregate:

- ▶ Proxy statements soliciting shareholders’ votes on the acquisition of real estate
- ▶ 1933 Act registration statements (e.g., Forms S-1, S-3, S-4, S-11, equivalent foreign forms)
- ▶ 1934 Act registration statements (e.g., Forms 10, 20-F)

Rule 3-14 financial statements and pro formas must be provided in the above registration and proxy statements for each of the following completed or probable acquisitions:

- ▶ Completed acquisitions made during the most recent fiscal year or subsequent interim period that are over 20% significant but not over 50% (excluding those properties for which results have already been reflected in the registrant's post-acquisition audited financial statements for at least nine months or for which financial statements are not yet required because of the 74-day extension period discussed further below)
- ▶ Completed acquisitions made during the most recent fiscal year or subsequent interim period that are over 50% significant, unless their results have been reflected in the registrant's post-acquisition audited financial statements for at least nine months
- ▶ Probable acquisitions that are over 50% significant
- ▶ Probable acquisitions that are over 20% significant but not over 50%, and completed acquisitions in this same range that are still within the 74-day extension period if the aggregate significance of individually insignificant acquisitions exceeds 50% (see the *Aggregation of individually insignificant properties for registration statements and proxy statements* section above for further discussion of related significance considerations and the specific pro formas required for these acquisitions)

A registrant⁴ must either provide the required financial statements and pro formas within the applicable registration statement or, if permitted by the form, within a Form 8-K that is incorporated by reference into the registration statement.

How we see it

We generally believe an acquisition is probable when a public announcement is made by the registrant or when a binding agreement between the parties is in place. This usually occurs when the major provisions of the acquisition transaction have been agreed to in writing (i.e., a definitive agreement). The SEC staff generally considers acquisitions probable if they are conditioned only upon obtaining financing or approval by shareholders or regulators or if they are disclosed in the registration statement.

Management should consult legal counsel when evaluating whether acquisitions are probable.

The SEC staff will not declare a registration statement or post-effective amendment effective unless all required Rule 3-14 financial statements and pro formas have been provided. When drawing down on an active shelf registration, a registrant must provide Rule 3-14 financial statements and pro formas for any completed acquisitions that are more than 50% significant and not included in the registrant's audited results for at least nine months.

While Rule 3-14 financial statements and pro formas are not otherwise required when drawing down on a shelf, a registrant must determine whether a significant completed or probable acquisition, or a series of individually insignificant acquisitions, constitutes a "fundamental change" that would require a post-effective amendment to the registration statement. It is the responsibility of management to determine what constitutes a "fundamental change," which has not been defined by the SEC.

Registrants must separately consider when they need to file financial statements and pro forma information in Form 8-K filings and registration statements.

How we see it

- ▶ Registrants that are nearing the deadline to update an expiring shelf registration statement should prepare to report on significant property acquisitions sooner than they normally would in a Form 8-K.
- ▶ We believe it is uncommon for a property acquisition to be identified as a fundamental change. However, the determination is a legal matter that a registrant should discuss with its legal counsel.

Rule 3-14 financial statements and pro formas for a completed acquisition that is more than 20% significant but no more than 50% significant may be omitted from a registration statement that is filed or becomes effective within 74 days of consummation. This is interpreted as 70 calendar days after the Item 2.01 Form 8-K due date. However, the registrant is still required to file Rule 3-14 financial statements and pro formas in an Item 9.01 Form 8-K by the 71st day. This exception does not apply when individually insignificant properties aggregate to more than 50% significance.

How we see it

When a registrant believes Rule 3-14 financial statements may be required, particularly when the 74-day extension does not apply, management should try to negotiate into the purchase agreement access to historical financial records of the acquired property that would assist in compiling the required pro formas.

Contents of required financial statements

Rule 3-14 requires audited income statements for the most recent fiscal year and the most recent year-to-date interim period before the acquisition of the real estate operation. These statements may be limited to statements of revenues and expenses, excluding items that are not comparable to the proposed future operations of the property (e.g., expenses related to mortgage interest, leasehold rental, depreciation, amortization, corporate overhead, income taxes). Registrants can file audited financial statements covering a period of nine to 12 months to satisfy the requirement for one year of Rule 3-14 financial statements, as permitted under Rule 3-06.

Registrants must include the following footnote disclosures in Rule 3-14 financial statements:

- ▶ The type of omitted expenses and the reasons why they are excluded from the financial statements
- ▶ A description of how the financial statements presented are not indicative of the results of operations of the acquired real estate operation going forward because of the omitted expenses
- ▶ Information about the real estate operation's operating, investing and financing cash flows, to the extent available

The SEC staff will not accept audited financial statements for a rolling nine- to 12-month period before an acquisition in lieu of audited statements of the latest fiscal year of the property. Additionally, the SEC has said that pre- and post-acquisition periods cannot be combined to meet the requirement to provide separate financial statements.

Rule 3-14 financial statements for properties with a rental history between three and nine months can be unaudited under existing SEC staff guidance. Registrants can ask the SEC staff for relief from the audit requirement if the rental history is between nine months and one year.

See Appendix A for an example of Rule 3-14 financial statements.

Additional required disclosures

Additionally, for each real estate operation for which audited historical financial statements are required to be filed, material factors considered by the registrant in assessing the real estate operation must be described with specificity in the filing, including:

- ▶ Sources of revenue (including, but not limited to, competition in the rental market, comparative rents and occupancy rates)
- ▶ Sources of expense (including, but not limited to, utility rates, property tax rates, maintenance expenses and capital improvements anticipated)

The disclosures must also indicate that the registrant is not aware of any other material factors relating to each real estate operation that would cause the reported financial statements not to be indicative of future operating results.

REIT formation transactions

A newly formed REIT that has no significant operations may acquire operating properties immediately before filing for an IPO on Form S-11 and may plan to acquire additional properties upon closing the IPO transaction or soon after the IPO. The SEC staff allows these registrants to compute individual and aggregate significance at the filing date or the effective date of the Form S-11 by substituting the sum of the total cost of properties acquired immediately before the filing or effectiveness of the S-11 and any probable acquisitions for total assets in the denominator of the investment test. Rule 3-14 financial statements for each individually significant property must be included in the registration statement.

In addition, pro formas that reflect only the significant properties may be provided, unless the aggregate significance of the remaining properties exceeds 50%. In that case, the pro formas must reflect all of the properties to the extent material.

Illustration 6 – Measuring significance in a REIT formation transaction

Company E, a newly formed REIT, filed for an IPO on Form S-11 on 9 July 20X2. The table below summarizes properties Company E acquired immediately before filing its registration statement and those that are probable of being acquired.

Completed acquisitions	Cost	Significance	Probable acquisitions	Cost	Significance
Property A	\$ 4.5m	17%	Property D	\$ 5.0m	19%
Property B	\$ 6.0m	22%	Property E	\$ 2.5m	9%
Property C	\$ 7.0m	26%	Property F	\$ 2.0m	7%
Total Cost (denominator)	\$ 27.0m				

Analysis: Because the significance of properties B and C exceed 20% individually and the properties have already been acquired, Rule 3-14 financial statements for each of these properties must be included in the registration statement. In addition, pro formas reflecting all six acquisitions must be included because the aggregate significance of properties A, D, E and F is 52%.

Illustration 7 – REIT formation transaction including related properties

Assume the same facts as described in Illustration 6, except that properties D, E and F are under common management before the acquisition. These properties meet the related property criteria of Rule 3-14 and must be evaluated together as if they were a single property.

Analysis: Because the significance of properties D, E and F together is 35%, Company E must also include Rule 3-14 financial statements of these properties in the registration statement. However, Company E may elect to provide the financial statements of these three properties on a combined basis for the periods they are under common management. The pro formas could exclude Property A because it is not significant, and aggregate significance is no longer relevant.

Blind pool offerings

A “blind pool” registration statement allows registrants to sell securities to purchase real estate operations that are not identified at the effective date of the registration statement. Item 20.D of SEC Industry Guide 5 requires that a registrant in this situation file a sticker supplement to the prospectus during the distribution period (i.e., the period during which the registrant is conducting a continuous 1933 Act registered offering) describing each property that has not been identified and disclosed previously whenever a reasonable probability exists that a property will be acquired.

A registrant in this situation also must consolidate all sticker supplements into a post-effective amendment that must be filed at least once every three months during the distribution period. This amendment must include or incorporate by reference Rule 3-14 financial statements and pro formas that have been filed or should have been filed (considering the 71-calendar-day extension) on Form 8-K for all significant property acquisitions.

Pro forma information is also required for any significant acquisitions for which Rule 3-14 financial statements are filed. However, unlike a post-effective amendment filed as a result of a fundamental change, a post-effective amendment that consolidates sticker supplements doesn't have to include financial statements of significant property acquisitions that have not yet been filed or not yet required to be filed (considering the 71-calendar-day extension) in a Form 8-K. Rule 3-14 financial statements of significant probable acquisitions or individually insignificant acquisitions, even if they are significant in the aggregate, also aren't required.

The prospectus updating regime in Item 20.D applies solely to real estate companies and not to other types of companies that may be subject to other parts of Industry Guide 5. These undertakings apply to all real estate acquisitions whether they fall under Rule 3-14 or Rule 3-05.

Measuring significance during the distribution period

The method used by registrants to compute significance of an acquisition during the distribution period applies to both acquisitions of real estate operations under Rule 3-14 and acquisitions of businesses under Rule 3-05.

A registrant should measure significance during the distribution period by comparing the total investment in the property, including any debt assumed by the registrant, with the sum of the following:

- ▶ The registrant's total assets as of the date of the acquisition, excluding the assets being acquired
- ▶ Proceeds, net of commissions, in good faith expected to be raised in the registered offering over the next 12 months

Registrants apply a modified significance test during the distribution period to prevent all acquisitions from being considered significant acquisitions.

An individual property is considered significant if its significance using the investment test exceeds 20%. Properties that are related or that were acquired from a single seller should be evaluated as if they are a single property.

How we see it

Common considerations when determining estimates of future proceeds include the pace of fundraising at the measurement date, the sponsor's experience raising capital in the public markets and recent offerings by similar registrants. To prepare for possible inquiries from the SEC staff, a registrant should have evidence to support its assumptions, as well as documentation of its process for determining estimated proceeds.

Distribution period reporting requirement

Rule 3-14 financial statements and pro formas of significant properties acquired during the blind pool distribution period should be provided in Form 8-K.

Updated financial statements would not be required in the Form 8-K if "substantially the same information" was previously filed. (See the *When to present Rule 3-14 financial statements* section.)

Reporting acquisitions after the distribution period

While companies do not file sticker supplements after the distribution period is completed, the requirement to include Rule 3-14 financial statements and pro formas of significant acquired properties on Form 8-K remains in effect.

Until a registrant files its first annual report after the distribution period ends, significance of an individually significant property should be computed by comparing the total investment in the property to the registrant's total assets as of the acquisition date, excluding the assets being acquired.

For any registration statements filed after the distribution period but before the next annual report is issued, registrants also must evaluate the aggregate significance of individually insignificant acquisitions made after the end of the distribution period. For this purpose, the registrant would compute significance based on assets as of the end of the distribution period, using either the pro forma total assets reported in its most recent Form 8-K filed during the distribution period or its total assets reported in its most recent interim period financial statements filed during the distribution period.

Properties securing mortgage loans

Acquisition, development and construction (ADC) arrangements

A registrant may originate a mortgage loan that is secured by a real estate operating property that in substance represents an investment in real estate or a joint venture rather than a loan. These loans may constitute an ADC arrangement as described in ASC 310, *Receivables*. ADC arrangements may have some of the following characteristics:

- ▶ The lender participates in expected residual profits.
- ▶ The lender provides all of the cash flows to acquire and complete the project, including agreeing to the addition of interest to the loan balance rather than receiving payment from the borrower.
- ▶ The lender is able to look only to the property itself to recover the loan. The borrower is not at risk through guarantees or pledging other collateral, nor are there unconditional contracts with third parties that ensure recovery of the loan.

- ▶ The lender's ability to recover principal and interest depends solely on the sale of the property or the obtaining of permanent financing from another independent source.

SEC Staff Accounting Bulletin (SAB) Topic 1.I. states that properties that secure loan arrangements that meet the definition of an ADC arrangement under ASC 310 are within the scope of Rule 3-14.

1933 Act financial statement requirements

Rule 3-14 financial statements of operating properties securing ADC loans are required in all 1933 Act registration statements for any single property for which the amount loaned or to be loaned is 20% (10% under current guidance) of the greater of offering proceeds or total assets of the registrant at the latest year-end balance sheet. The information required by Items 14 and 15 of Form S-11 also should be included with respect to these investment-type arrangements. However, if no single loan exceeds 20% (10% under current guidance), but the aggregate of such loans exceeds 20%, a description of the general character of the properties and arrangements is required in a note to the financial statements. Such information may include a description of the terms of the arrangements, participation by the registrant in expected residual profits, and property types and locations.

How we see it

We believe that the SEC staff may not object to a registrant using higher thresholds as noted above due to the amendments to Rule 3-14. However, a registrant should contact the SEC staff to confirm it can use the higher thresholds until the SEC staff updates SAB Topic 1.I or otherwise comments on how the amendments affect it.

1934 Act financial statement requirements

Annual reports on Form 10-K must include the following financial information for operating properties securing ADC loans:

- ▶ If more than 20% of the registrant's total assets are invested in a single loan, financial statements of the underlying operating property are required (except in annual reports to shareholders where only summary data is required).
- ▶ If more than 10% but less than 20% of the registrant's total assets is invested in a single loan, summarized financial information of the operating property is required.
- ▶ When individual loans are not significant but in the aggregate exceed 20% of the registrant's total assets, a description of the properties and arrangements is required in a footnote to the financial statements.

Entering into a significant ADC arrangement (i.e., greater than 20% significant) also triggers a requirement to file the financial statements of the underlying operating property in a Form 8-K.

Significance of ordinary loan arrangements

SAB Topic 1.I. also states that, in certain circumstances, information may be required about operating properties that secure mortgage loans, even when the terms do not constitute ADC arrangements. Generally, if investment risks exist due to substantial asset concentrations, financial and other information should be included in the filing with respect to operating properties securing a mortgage loan that represents a significant amount of the registrant's assets.

If more than 20% of the greater of offering proceeds or total assets at the latest year-end balance sheet date have been or will be invested in a single loan (or in several loans on related properties to the same or affiliated borrowers), financial statements of the property securing the loan are required in both 1933 Act and 1934 Act filings. Properties would be considered related if they are subject to cross-default or collateralization agreements.

Endnotes:

- ¹ The SEC also amended the Rule 3-05 reporting requirements. Refer to our Technical Line, [*Applying the SEC's new requirements for significant acquired businesses*](#), for additional guidance on applying this rule.
- ² When a registrant has triple net leased one or more real estate properties to a single lessee/tenant (including in the capacity as co-lessee or guarantor), and such properties represent a "significant" portion of the registrant's assets, an investor may need to consider the lessee's financial statements or other financial information in order to evaluate the risk to the registrant from this asset concentration. An asset concentration is generally considered "significant" if it exceeds 20% of the registrant's assets as of its most recent balance sheet. This applies to annual reports and registration statements.
- ³ The Division of Corporation Finance Financial Reporting Manual is available at <https://www.sec.gov/corpfin/cf-manual>.
- ⁴ Automatic shelf registration statements and post-effective amendments of well-known seasoned issuers (WKSIs) become effective immediately upon filing. WKSIs must comply with all Rule 3-14 reporting requirements as of the effective date of those registration statements.

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SCORE No. CC0373
(Updated 14 January 2021)

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Appendix A: Example Rule 3-14 financial statements

The following is an example of the form and content of Rule 3-14 financial statements. These statements were prepared assuming that the property was acquired in the fourth quarter of 2020 from an unrelated party. The required pro forma information reflecting the impact of the acquisition to the registrant has been omitted from this presentation.

Property I
Statements of Revenues and Certain Expenses
Year Ended December 31, 2019, and Nine Months Ended September 30, 2020 (unaudited)
(In thousands)

	Nine Months Ended September 30, 2020 (Unaudited)	Year Ended December 31, 2019
Revenues		
Rental revenue	\$ 11,400	\$ 15,900
Parking and other	1,500	2,100
Total revenues	12,900	18,000
Certain expenses		
Operating expenses	3,700	5,000
Taxes and insurance	1,200	1,600
Total certain expenses	4,900	6,600
Revenues in excess of expenses	\$ 8,000	\$ 11,400

See accompanying notes

1. Basis of Presentation

The accompanying statements of revenues and certain expenses include the operations of Property I (the Property), an office building.

The accompanying statements of revenues and certain expenses relate to the Property and have been prepared for the purpose of complying with Rule 3-14 of Regulation S-X promulgated under the Securities Act of 1933, as amended. Accordingly, the statements are not representative of the actual operations for the periods presented as revenues, and certain operating expenses, which may not be directly attributable to the revenues and expenses expected to be incurred in the future operations of the Property, have been excluded. Such items include depreciation, amortization, management fees, interest expense, interest income and amortization of above- and below-market leases.

2. Summary of Significant Accounting Policies

Revenue Recognition

In accordance with ASC 842, the Property recognizes rental income on a straight-line basis over the term of the related leases when collectibility is probable and records amounts expected to be received in later years as deferred rent receivable. For lease arrangements when it is not probable that the Property will collect all or substantially all of the remaining lease payments under the term of the lease, rental revenue is limited to the lesser of the rental revenue that would be recognized on a straight-line basis (as applicable) or the lease payments that have been collected from the lessee. Differences between rental revenue recognized and amounts contractually due under the lease agreements are credited or charged to straight-line rent receivable or straight-line rent liability, as applicable. Tenant reimbursements for common area maintenance and other recoverable expenses are recognized when the services are provided and the performance obligations are satisfied. Tenant reimbursements are accounted for as variable lease payments and are recorded as rental income on the Property's statement of operations.

Parking and other revenue is revenue that is derived from the tenants' use of telecommunications, parking and the fitness center. Parking and other revenue is recognized when the related services are utilized by the tenants.

Use of Estimates

Management has made a number of estimates and assumptions relating to the reporting and disclosure of revenues and certain expenses during the reporting periods to present the statements of revenues and certain expenses in conformity with US GAAP. Actual results could differ from those estimates.

3. Minimum Future Lease Rentals

There are various lease agreements in place with tenants to lease space in the Property. As of September 30, 2020, the minimum future cash rents receivable under noncancelable operating leases in each of the next five years and thereafter are as follows (unaudited):

2020 (three months ending December 31, 2020)	\$ 3,600
2021	14,800
2022	14,600
2023	13,100
2024	12,200
2025	8,800
Thereafter	17,600
	\$ 84,700

Leases generally require reimbursement of the tenant's proportional share of common area, real estate taxes and other operating expenses, which are excluded from the amounts above.

4. Tenant Concentrations

For the year ended December 31, 2019, and the nine months ended September 30, 2020, three tenants represented 80% and 85% (unaudited), respectively, of the Property's rental revenues.

5. Related Party Transactions

An affiliate of the owner of the Property provides engineering services to the Property. For the year ended December 31, 2019, and the nine months ended September 30, 2020, \$60 and \$50 (unaudited) of engineering related services, respectively, are included in the Property's operating expenses.

6. Commitments and Contingencies

The Property is subject to various legal proceedings and claims that arise in the ordinary course of business. These matters are generally covered by insurance. Management believes that the ultimate settlement of these actions will not have a material adverse effect on the Property's results of operations.

7. Subsequent Events

The Property evaluated subsequent events through January 20, 2021, the date the financial statements were available to be issued.

Appendix B: Summary of key amendments to Rule 3-14 requirements

The following table compares the amended requirements for providing Rule 3-14 financial statements to those of the legacy rule.

Description of financial statement requirements	Amended Rule 3-14 requirements	Legacy Rule 3-14 requirements
Significance threshold for individually significant acquisitions of real estate	Greater than 20% using the investment test	Greater than 10% using the investment test
Aggregate significance threshold and reporting requirements for individually insignificant acquisitions of real estate	<ul style="list-style-type: none"> ▸ Greater than 50% using the investment test ▸ All individually insignificant acquisitions are aggregated. ▸ Financial statements are required only for acquisitions greater than 20% significant. 	<ul style="list-style-type: none"> ▸ Greater than 10% using the investment test ▸ Aggregation is performed separately for businesses acquired subject to Rule 3-05 and real estate operations acquired subject to Rule 3-14. ▸ Financial statements are required for each property that has a significance of 5% or more. Registrants also must assess whether financial statements for the majority (i.e., more than 50%) of the acquisitions based on purchase price have been provided. If not, the registrant must provide financial statements for other acquired properties below the 5% level to meet the 50% threshold.
Investment test calculation	Significance is calculated as investment in and advances to the acquired property as a percentage of average worldwide market value of the registrant's voting and non-voting common equity, if available. The numerator includes debt assumed by the registrant in the acquisition only if the registrant does not have a worldwide market value and uses assets in the test.	Significance is calculated as investment in and advances to the acquired property as a percentage of total assets. The numerator includes any debt assumed by the registrant in the acquisition.
Periods of financial statements required	Most recent audited fiscal year and most recent year-to-date unaudited interim period	<p>For property acquired from unrelated party – most recent audited year and latest unaudited year-to-date interim period</p> <p>For property acquired from related party – three years of audited financial statements (two years for smaller reporting companies) and latest unaudited year-to-date interim period</p>

Description of financial statement requirements	Amended Rule 3-14 requirements	Legacy Rule 3-14 requirements
Application of Rule 3-06, which permits a registrant to file financial statements covering a period of nine to 12 months to satisfy a requirement for filing financial statements for a period of one year	Included in the scope of Rule 3-06	Not included in the scope of Rule 3-06
Timing of filing Rule 3-14 financial statements in registration statements and proxy statements	Rule 3-14 financial statements do not need to be included if the acquisition is 50% significant or less, and either (1) the consummation of the acquisition has not yet occurred or (2) the filing or effectiveness date of the registration statement (or mailing of the proxy statement) is no more than 74 days after the consummation of the acquisition of the real estate, and the financial statements have not previously been filed by the registrant. (Exception: if the aggregated significance of individually insignificant acquisitions exceeds 50%, financial statements are required for acquisitions more than 20% significant.)	A registrant that has acquired a significant property must include financial statements in the registration statement, even if they are not yet due to be reported on Form 8-K.
Periods for which significance of acquired properties should be considered in registration statements	Registrant is not required to provide Rule 3-14 financial statements in registration statements and proxy statements once the acquired real estate operation is reflected in registrant's post-acquisition audited financial statements for nine months.	Financial statements must be provided for each completed purchase of an individually significant property made during each year of the registrant's financial statements that are presented (i.e., significance measured at the date of the respective acquisitions).
Interim financial statements	Rule 3-14 financial statements are required for the most recent year-to-date period before the acquisition.	While legacy Rule 3-14 does not explicitly require interim financial statements, registrants have historically included interim financial statements based on the application of Article 11, <i>Pro Forma Financial Information</i> , and interpretations by SEC staff.
Net lease arrangements	Rule 3-14 does not differentiate between acquisitions of properties subject to triple net leases and other real estate operations. However, properties subject to triple net leases require a registrant to evaluate whether there is a significant asset concentration when filing annual reports and registration statements.	A registrant that acquired a property subject to a triple net lease that meets the significance threshold is required to present the financial statements of the lessee.

Appendix C: Comparison of requirements of amended Rules 3-14 and 3-05

Rule 3-14 requires companies to include abbreviated audited financial statements for significant consummated or probable acquisitions of real estate operations in registration statements and proxy statements. Rule 3-05 requires companies to include audited financial statements of significant acquisitions or probable acquisitions of businesses in registration statements, including IPOs. Financial statements for significant acquisitions under both rules are also required to be reported on Form 8-K. This table does not reflect the requirements for blind pool offerings or net lease arrangements.

Description of financial statement requirements	Rule 3-14	Rule 3-05
Financial statements	Abbreviated income statement	Full financial statements, but abbreviated financial statements can be presented when certain conditions are met
S-X 1-02(w) tests performed to determine significance	Investment test	Significance is determined by the highest result of these three tests: <ul style="list-style-type: none"> ▸ Investment test ▸ Asset test ▸ Income test
Significance threshold for individually significant acquisition	Greater than 20%	Greater than 20%
Periods of financial statements required	Most recent fiscal year and the most recent year-to-date interim period	Depends on significance: <ul style="list-style-type: none"> ▸ Exceeds 20% but not 40%: most recent fiscal year and most recent year-to-date interim period ▸ Exceeds 40%: two most recent fiscal years and most recent year-to-date interim period with a comparative prior period Note: abbreviated financial statements cover the most recent fiscal year and interim period.
Periods for which significance of acquired properties or businesses should be considered in registration statements	Rule 3-14 financial statements are not required once the operating results of the acquired operation have been reflected in the registrant's audited consolidated financial statements for at least nine months.	Rule 3-05 financial statements are not required once the operating results of the acquired business have been reflected in the registrant's audited consolidated financial statements for at least: <ul style="list-style-type: none"> ▸ Nine months, if the acquisition is more than 20% significant but not more than 40% significant ▸ A complete fiscal year, if the acquisition is more than 40% significant

Description of financial statement requirements	Rule 3-14	Rule 3-05
Individually insignificant acquisitions	<p>Financial information required when the aggregate significance of all insignificant acquisitions exceeds 50% under the investment test:</p> <ul style="list-style-type: none"> ▸ Pro formas that depict the aggregate impact of all individually insignificant acquired or to-be-acquired real estate operations in all material respects ▸ Rule 3-14 financial statements covering at least the most recent fiscal year and the most recent interim period are required for any acquired or to-be-acquired real estate operation that exceeds the 20% significance threshold. 	<p>Financial information required when the aggregate significance of all insignificant acquisitions exceeds 50% under the asset test, investment test or income test:</p> <ul style="list-style-type: none"> ▸ Pro formas that depict the aggregate impact of all individually insignificant acquired or to-be-acquired businesses in all material respects ▸ Rule 3-05 financial statements covering at least the most recent fiscal year and the most recent interim period are required for any acquired or to-be-acquired business that exceeds the 20% significance threshold.
Requirements for conducting offerings under an effective shelf registration statement (i.e., shelf offering)	<p>A shelf registration statement must be updated before registrants draw down on it to include Rule 3-14 financial statements and pro formas for:</p> <ul style="list-style-type: none"> ▸ Completed or probable acquisitions that are more than 50% significant ▸ Completed or probable acquisitions that are not more than 50% significant but represent a fundamental change 	<p>A shelf registration statement must be updated before registrants draw down on it to include Rule 3-05 financial statements and pro formas for:</p> <ul style="list-style-type: none"> ▸ Completed or probable acquisitions that are more than 50% significant ▸ Completed or probable acquisitions that are not more than 50% significant but represent a fundamental change
Allows grace period (74 calendar days after the acquisition) to provide financial statements of a significant acquisition in a registration statement	<p>Yes, for financial statements of an acquired business that exceeds 20% significance but does not exceed 50%. (Exception: if the aggregated significance of individually insignificant acquisitions exceeds 50%, financial statements are required for acquisitions more than 20% significant.)</p>	<p>Yes, for financial statements of an acquired business that exceeds 20% significance but does not exceed 50%. (Exception: if the aggregated significance of individually insignificant acquisitions exceeds 50%, financial statements are required for acquisitions more than 20% significant.)</p>
Application of Rule 3-06, which permits a registrant to file financial statements covering a period of nine to 12 months to satisfy a requirement for filing financial statements for a period of one year	Yes	Yes
Allows use of pro forma financial information to measure significance when filed in a Form 8-K or registration statement for a previous significant acquisition	Yes	Yes