KPMG
cutting through complexity

Defining Issues®

February 2014, No. 14-8

SEC Updates Guidance for Reporting Real Estate Acquisitions

The SEC staff recently revised guidance in its Financial Reporting Manual (FRM) that explains when a registrant needs to file audited financial statements for acquired real estate properties.[1]

Key Facts

The SEC staff's revised guidance about reporting real estate acquisitions may result in fewer acquisitions in the real estate industry requiring financial reporting by:

- Allowing a registrant to use previously filed pro forma financial information to calculate an acquisition's significance;
- Eliminating certain individually insignificant property acquisitions from the population of financial statements potentially required in a registrant's registration or proxy statement; and
- Providing for a larger base on which to calculate property significance during the distribution period for a blind pool offering.

In addition, Rule 3-14 financial statements are now required for acquisitions of properties subject to triple net leases that are at least 10 percent significant to a registrant but less than 20 percent significant.

Key Impact

Generally, the revised guidance should reduce the volume of real estate financial statements that must be filed by registrants that are active in the real estate industry, particularly real estate investment trusts (REITs).

Contents

[1] The SEC Division of Corporation Finance's Financial Reporting Manual is available at www.sec.gov/divisions/corpfin/cffinancialreportingmanual.pdf.

Section 2300 of the SEC staff's FRM provides extensive interpretive guidance to comply with Rule 3-14 of Regulation S-X.[2] This regulation requires a registrant to file abbreviated income statements for significant real estate operations that have been acquired, or will be acquired, if they meet certain significance thresholds. Significance is generally determined by comparing the purchase price of an acquired real estate property to a registrant's total assets as of its latest audited fiscal year-end filed with the SEC.

Real estate operations refer to properties that generate revenue solely by leasing properties such as office, apartment, and industrial buildings, shopping centers, and malls. The acquisition of properties that generate revenues from operations other than leasing real estate, such as nursing homes and hotels, are not real estate operations and do not fall within the scope of Rule 3-14. Those acquisitions are considered business acquisitions and are covered by Rule 3-05 of Regulation S-X.[3]

Under Rule 3-14, financial statements for real estate properties must be audited. However, now a registrant may, without seeking permission from the SEC, file unaudited financial statements for an operating property with a rental history of more than three months but less than nine months. When the rental history is less than three months, financial statements of the operating property are not required.

Acquiring Equity Interest in Pre-existing Entities

A registrant that acquires an equity interest in a pre-existing legal entity (e.g., a partnership, LLC, or corporation) that only holds real estate under lease and related debt should follow the reporting requirements of Rule 3-14 if the acquisition is 10 percent or more significant. The SEC staff also will accept financial statements meeting the requirements of Rule 3-05 in this situation.

The SEC staff clarified that when a registrant acquires an equity interest in a pre-existing legal entity that engages in other activities, such as property management or development in addition to holding real estate, the registrant should consider whether the acquisition is a business rather than a real estate property. If, based on the significance of the other activities it is determined that the entity is a business, financial statements meeting the requirements of Rule 3-05 are required if the acquisition exceeds 20 percent significance.

---

[2] Rule 3-14 of Regulation S-X, Special Instructions for Real Estate Operations to Be Acquired, available at www.sec.gov. Abbreviated income statements may exclude items such as historical mortgage interest and depreciation, which are not comparable to the proposed future operations of the property.

[3] Rule 3-05 of Regulation S-X, Financial Statements of Business Acquired or to Be Acquired, available at www.sec.gov.

Pro Forma Financial Information

If a registrant completes a significant real estate property acquisition, it must file a Form 8-K that includes audited financial statements and pro forma financial information.[4] Under new guidance in the FRM, a registrant may now use previously filed pro forma financial information as a base to calculate the significance of a new real estate property acquisition. Using pro forma financial information is not required, but if a registrant chooses to do so, it must be used consistently for all property acquisitions for the remainder of the fiscal year. The pro forma effects of any other transaction, including insignificant acquisitions, should be excluded from the base to calculate the significance of a new real estate property acquisition.

The SEC staff has reduced the number of properties for which financial statements must be provided in registration and proxy statements by eliminating the need to consider individually insignificant properties acquired *during* a registrant's fiscal year.

Significance Testing for Registration and Proxy Statements

For registration and proxy statements, a registrant must provide audited financial statements for each real estate property that is acquired, or is probable of acquisition, that individually is at least 10 percent of the registrant's total assets in its latest audited fiscal year balance sheet filed with the SEC or pro forma financial information filed for a significant real estate property acquisition as discussed above.[5]

Audited financial statements also are required for the majority (greater than 50 percent) of all individually insignificant (i.e., less than 10 percent significant) acquisitions made, or to be made, *subsequent* to the end of the most recently completed fiscal year that aggregate to over 10 percent of the registrant's total assets as of the latest audited fiscal year balance sheet date.[6]

Property acquisitions that would not require Rule 3-14 financial statements even if individually significant, such as certain triple net leased properties as discussed below, and newly constructed properties, are excluded from the significance calculation.

As part of its revised guidance about individually insignificant acquisitions, the SEC staff:

- Reduced the number of properties for which financial statements must be provided by eliminating consideration of individually insignificant properties acquired during a registrant's fiscal year; and

[4] Form 8-K requires pro forma financial information to comply with Article 11 of Regulation S-X. The purchase of real estate by a company engaged in real estate activities is not considered to be an acquisition in the ordinary course of business.

[5] The acquisition of a group of related properties is treated as a single acquisition in measuring significance. Properties are *related* if they are under common control or management, the acquisition of one property is conditioned on the acquisition of each other property, or each acquisition is conditioned on a single common event.

[6] This requirement excludes registration statements filed under Rule 462(b) and post-effective amendments filed to reflect a fundamental change.

- No longer requires a registrant to automatically file financial statements for properties acquired from related parties that are less than 5 percent significant.

The required financial statements for a registration or proxy statement are summarized below.

Individually significant (≥10 percent significant) acquisitions	• Financial statements for each acquisition completed during each year the registrant's financial statements are presented and each acquisition completed after the end of the most recently completed fiscal year • Financial statements for each probable acquisition
Individually insignificant (<10 percent significant) acquisitions completed after the most recent fiscal year and probable acquisitions that aggregate to at least 10 percent significant	• Financial statements for each acquisition completed after the most recent fiscal year and each probable acquisition that is 5 percent or greater significant • If the total of the purchase prices of the 5 percent or greater acquisitions does not exceed 50 percent of the total purchase price of all individually insignificant acquisitions, financial statements of other insignificant acquisitions completed after the most recent fiscal year and probable acquisitions are needed until financial statements for more than 50 percent of the total purchase price are provided.

Blind Pool Offerings

During the distribution period for a blind pool offering a registrant can now measure significance of an acquired property by comparing its investment in the property to its total assets as of the date of acquisition *plus* the offering proceeds expected to be raised in good faith over the next 12 months.[7] In

[7] A blind pool offering occurs when approximately 25 percent or greater of the offering proceeds have not been allocated for an identified use. A distribution period is the period when a registrant conducts a continuous offering and may include subsequent offerings to the initial registration statement.

estimating the proceeds, a registrant should consider the pace of fundraising as of the measurement date, its prior public fundraising experience, and offerings by similar companies. Because the denominator in the significance calculation may be significantly increased in these circumstances, fewer acquired properties should require financial statements. The acquisition of an otherwise individually insignificant property from a related party is no longer considered significant for blind pool offerings.

The SEC staff clarified that after a registrant's blind pool offering distribution period ends, and before it files its first annual report after the distribution period ends, it should measure significance of acquired properties using its total assets as of the acquisition date of each property.

When a property subject to a triple net lease is 20 percent significant, financial statements of the *lessee* are required. However, those financial statements will not be the basis for the pro forma financial information required by Article 11 of Regulation S-X.

Triple Net Leases

A triple net lease requires a single lessee to pay costs for a property that would normally be paid by the owner (lessor), such as property taxes, insurance, utilities, and maintenance costs. When a property is subject to triple net lease and is significant to a registrant, it is generally more meaningful for investors to have information demonstrating the lessee's ability to make payments rather than the financial statements for the property itself. If a property or group of properties leased by a single lessee (including co-lessees or guarantors) represents a significant asset concentration for a registrant (generally over 20 percent of total assets of the registrant), audited financial statements of the lessee would typically need to be provided.

Now the FRM specifies that if the asset concentration is below 20 percent of the total assets of the registrant, Rule 3-14 financial statements are required when a triple net leased property is at least 10 percent of the registrant's total assets and there is a rental history. The SEC staff will accept audited financial statements of the lessee in lieu of Rule 3-14 financial statements.

Contact us: This is a publication of KPMG's Department of Professional Practice 212-909-5600

Contributing authors: Melanie F. Dolan and Dexter A. Metcalfe

Earlier editions are available at: http://www.kpmginstitutes.com/financial-reporting-network