GRANT THORNTON LLP
Grant Thornton Tower
171 N. Clark Street, Suite 200
Chicago, IL 60601-3370

D +1 312 856 0200
S linkd.in/grantthorntonus
twitter.com/grantthorntonus

July 29, 2019

Office of the Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Via Email to rule-comments@sec.gov

Re: File Number S7-05-19

Proposed Rule: Amendments to Financial Disclosures about Acquired and Disposed Businesses

Dear Office of the Secretary:

Grant Thornton LLP appreciates the opportunity to comment on the Securities and Exchange Commission's (SEC or Commission) Proposed Rule, *Amendments to Financial Disclosures about Acquired and Disposed Businesses*. We applaud the Commission's efforts to improve the financial information about acquired and disposed businesses provided to investors, facilitate capital formation, and reduce complexities and costs to prepare disclosures. We encourage the Commission to continue its outreach to investors, registrants, and other stakeholders as part of its Disclosure Effectiveness Initiative.

Executive summary

We broadly support the Commission's objective outlined in the proposal and are providing our firm's perspective gained primarily from serving public companies as independent accountants, including interaction with the SEC staff in this capacity. The Commission has proposed several changes to the existing rules that will impact a large population of registrants. Our comments in this letter are primarily focused on providing certain recommendations to clarify the application of the proposed rules, define terms used in the proposed rules, codify existing interpretive guidance, as well as highlight challenges in applying portions of the proposed rules, such as changes to pro forma financial information. While we also provide our views on certain proposed amendments that would affect the information available to investors, we defer to investors' input to inform the Commission's future rulemaking. Further, there exists a significant amount of SEC staff interpretive guidance related to financial information for acquisitions and dispositions. To the extent such guidance is not being codified into the final rules, we encourage the staff to stand ready to quickly update such interpretive guidance upon issuance of the final rules to avoid any confusion on how the new rules would be applied.

Significance tests

Investment test for acquired businesses

Aggregate worldwide market value of voting and non-voting securities

We support the use of a readily determinable fair value amount as the denominator in the investment test. However, we observe that aggregate worldwide market value of voting and non-voting equity securities may not always be reflective of the fair value of a registrant, such as when a significant portion of a registrant's common stock is held by its affiliates or when the capital structure includes preferred stock. If the Commission determines to use the aggregate worldwide market value as the denominator in the investment test, we recommend that the final rule provide instructions on how this value should be computed.

We also recognize that a registrant's stock price could be volatile and could fluctuate for several reasons other than those related to the underlying operations of the registrant. There could also be significant events that occur after the most recently completed fiscal year that could have a material impact on the registrant's aggregate worldwide market value. Accordingly, we believe that computing aggregate worldwide market value using an average market value over some prescribed period, or using market value as of a date closer to the transaction, such as the end of the most recently completed fiscal quarter for which financial statements are required to be filed by S-X Rule 3-01, could reduce instances of anomalous results.

Contingent consideration

Where the registrant is not required to include the fair value of contingent consideration on the acquisition date in the financial statements, such as in the case of a business acquisition that constitutes an asset acquisition under GAAP, an acquisition of an equity method investee, or an acquisition of mortgages secured by underlying real estate properties, the proposal would require all contingent consideration (excluding sales-based milestones and royalties) to be included in the numerator for purposes of the investment test, unless the likelihood of payment is remote.

Deducting sales-based milestones and royalties from all contingent consideration to be included in the numerator could result in the under-identification of acquisitions that would materially affect the registrant's financial statements in the future. Further, as a point of reference, for business acquisitions that are accounted for under ASC 805, *Business Combinations*, the exclusion of sales-based milestones or royalties is not permitted in computing contingent consideration recorded in the financial statements on the acquisition date. If the Commission decides to exclude sales-based milestones and royalties from the numerator, we recommend that the final rule define these terms as well as include relevant implementation guidance. For instance, the Commission may consider clarifying whether the exclusion would apply to payment obligations triggered only when both sales-based and income-based milestones are met. We also recommend that the Commission clarify whether all contingent consideration should be included in the numerator if the likelihood of payment of all contingent consideration or any part thereof is more than remote.

Income test

We support the addition of a revenue component to the income test and believe that it would reduce instances of anomalous significance results. However, we also recognize that measuring significance using the lower of the income or revenue test would only partially address the concern highlighted in footnote 46 of the proposed rule. Expenses related to historical capitalization as well as infrequent expenses recorded in the historical financial statements of an acquired business can deem the acquisition insignificant, even though it is expected to have a material future impact on the registrant. Accordingly, we recommend that the Commission consider input received from investors on whether requiring pre-acquisition financial statements based on the lower of the revenue and income component would result in the under-identification of significant acquisitions and whether the Commission might use a lower threshold for the revenue test. We also recommend that the Commission clarify what constitutes “normal recurring revenue.”

Further, in our experience, income taxes could differ significantly based on several factors that are unique to an entity, such as its corporate form, ownership structure, and tax strategies. While using earnings after taxes could simplify the computation, it could also increase instances of anomalous results under the income test. Accordingly, we recommend that the Commission retain the requirement to perform significance test using pretax amounts.

Additionally, S-X Rule 3-09 requires a registrant to measure significance using the investment test and the income test under S-X Rule 1-02(w), substituting 20 percent for 10 percent. Given that equity method investees are not consolidated and the registrant only records their share in income or loss (or, if the fair value option is elected, the change in fair value), results of the revenue component might not be meaningful for determining significance.

Blind pool offerings

Consistent with existing interpretive guidance, the proposed rule would provide for certain adapted significance tests for the acquisition of real estate operations in a blind pool offering. At times, the registrant conducting a blind pool offering could acquire a business that is within the scope of S-X Rule 3-05, and not S-X Rule 3-14. Unlike when real estate operations are acquired, there are no accommodations, such as performing significance test using the aggregate of total assets and proceeds (net of commissions) that are expected to be raised in the next 12 months during the distribution period in the denominator, when the acquisition is within the scope of S-X Rule 3-05. We recommend that the Commission consider applying the adapted significance tests described above for acquisitions of real estate operations in blind pool offerings to S-X Rule 3-05 acquisitions in these circumstances.

Use of pro forma financial information to measure significance

The proposed rule would allow registrants to use pro forma financial information that gives effect only to significant acquisitions and dispositions that occurred after the most recently completed fiscal year for which financial statements are required to be filed by the registrant, provided that the required financial statements and pro forma information for such acquisitions and dispositions have been filed.

We support the expanded use of pro forma financial information to measure the significance of acquisitions and dispositions. We recommend that the SEC staff's current guidance outlined in Section 2025.3 of the *Financial Reporting Manual* (FRM), which requires registrants to use the approach (that is, using or not using pro forma information for performing significance tests) consistently for all acquisitions and dispositions until the next annual report on Form 10-K is filed, be codified in any final rule on this topic.

Additionally, there could be situations where the previously filed pro forma financial information gives effect to other transactions, such as an offering, or could be built on previously filed pro forma financial information that includes other transactions. Accordingly, we recommend that the Commission clarify in the final rule that pro forma financial information used to determine significance may be different from the pro forma financial information that was previously filed.

We also recommend that the Commission clarify how pro forma financial information for previous acquisitions or dispositions be used for determining the significance of subsequent acquisitions or dispositions in connection with an initial registration statement, given that pre-acquisition financial statements and pro forma financial information for the previous transactions could not have been previously filed in the case of a confidential submission and the first public filing of an IPO registration statement.

Financial statements of businesses acquired or to be acquired and real estate operations (S-X Rules 3-05 and 3-14, respectively)

Abbreviated financial statements

S-X Rule 3-05

We support the proposed amendments to permit a registrant to provide abbreviated financial statements in lieu of full financial statements if certain conditions are satisfied. One such condition is that the acquired business does not constitute substantially all of the assets and liabilities of the seller. We recommend that the Commission provide a threshold on what constitutes "substantially all of the assets and liabilities." Absent any threshold, there would likely be diversity in how registrants interpret this phrase.

In the proposing release, the Commission has recognized that there could be challenges in making allocations of the selling entity's corporate overhead, interest, and taxes when the acquired business constitutes only a small portion of the selling entity. However, we believe that the language in the proposed rule would allow registrants that acquire a significant portion of the selling entity to present abbreviated financial statements, as long as such business does not meet any of the other conditions outlined in the proposal. We recommend that the Commission consider investor input in assessing whether abbreviated financial statements in such situations satisfy investors' needs.

One of the other conditions in the proposal for providing abbreviated financial statements is that separate financial statements of the acquired business have not been previously prepared. We recommend that the Commission provide clarification on whether financial statements prepared on a comprehensive basis other than GAAP (such as tax-basis financial statements), financial statements prepared using Private Company Council alternatives, or financial statements prepared on a cash basis would constitute financial statements for this purpose.

We also recommend that the Commission clarify terms such as "division" and "impracticable" used in the proposed rule. Further, the Commission could consider clarifying that the condition related to businesses not being a separate entity, subsidiary, segment, or division also applies to any combination thereof. The Commission may also consider codifying staff guidance provided in Section 2065 of the FRM as well as SAB Topic 1.B, *Allocation of Expenses and Related Disclosure in Financial Statements of Subsidiaries, Divisions or Lesser Business Components of Another Entity,* as they relate to presenting carve-out financial statements to satisfy S-X Rule 3-05 requirements.

Where the acquired business is significant only under the investment test, we recommend that the Commission consider investor input on permitting registrants to provide an audited statement of assets acquired and liabilities assumed on the acquisition date on a fair value basis in lieu of the abbreviated financial statements.

S-X Rule 3-14

Proposed S-X Rule 3-14 defines "real estate operation" as a business that generates substantially all of its revenue through leasing of real property. We recommend that the Commission provide a threshold for what constitutes "substantially all."

Where the real estate operation is subject to a triple net lease, the current interpretive guidance requires a registrant to provide audited financial statements of the lessee or guarantor if the significance exceeds 20 percent. In contrast, the proposed rule would require a registrant to file abbreviated financial statements for significant real estate operations in such instances. In the request for comment, the Commission asked whether it should require summarized financial information for the lessee or guarantor in the financial statements. We believe that such a requirement would create challenges from an audit perspective. The financials statements of the lessee or guarantor may be unaudited or could have been audited by other auditors. Further, the lessee or guarantor could be significantly larger than the real estate operation being acquired, and auditing the summarized financial information using the materiality for the real estate operation could be impracticable.

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Omission of S-X Rule 3-05 financial statements

Initial public offerings

In the proposal, the Commission acknowledges that determinations related to business acquisitions pose unique challenges, tend to be episodic, and it can be difficult for registrants to efficiently make a determination of materiality. Accordingly, we believe that it may be challenging for registrants to determine whether any pre-acquisition financial statements would be material once the acquired business has been included in the audited post-acquisition results for full 12 months in the most recently completed fiscal year.

An entity may have consummated a very large acquisition in the year prior to the most recently completed fiscal year for which the financial statements are being provided in an IPO registration statement. In our experience, the acquired business could be larger than the registrant in some cases. While the registrant would be required to provide its historical financial statements for two years, the acquired business's financial statements would be limited to the period for which those are included in the registrant's post-acquisition results. Further, in our experience, disclosure pursuant to Regulation S-K, Item 303, *Management's discussion and analysis of financial condition and results of operations*, may not clearly isolate the effects of the acquisition on the results of operations. We encourage the Commission to consider investor input in assessing whether the proposed rule would provide them with the necessary information to make the investment decisions or whether there should be a requirement to present additional financial statements if the significance exceeds a certain threshold. For example, the Commission could consider requiring an IPO registrant to provide financial statements for the same number of periods as required in subsequent Securities Act and Exchange Act filings or using a 50 percent threshold, which is consistent with a registrant's requirement to provide an acquired business's historical financial statements for two or three years, as applicable, prior to proceeding with a securities offering.

Further, where the financial statements of an acquired business have not been included in the registrant's post-acquisition audited results for at least a full fiscal year, the registrant would be required to file pre-acquisition financial statements for the acquired business based on the level of significance. In contrast, S-X Rule 3-06 allows a registrant to file pre-acquisition financial statements for a nine-month period to satisfy the one-year requirement. We believe that the proposed requirements could result in confusion. For example, if an acquisition is consummated shortly after the most recently completed fiscal year for which financial statements are required under S-X Rule 3-01, the registrant would be permitted to apply Rule 3-06 and provide pre-acquisition financial statements for such a business for a nine-month period to satisfy S-X Rule 3-05 requirements. However, if the same acquisition is consummated in the first quarter of the most recently completed fiscal year for which financial statements are required, Rule 3-06 would not apply. Therefore, audited post-acquisition results that include the acquired business for at least nine months would not satisfy S-X Rule 3-05. This could result in requests for relief from providing any pre-acquisition financial statements once the acquisition is included in the audited financial statements of the registrant for at least a nine-month period. We recommend that for acquired businesses with significance between 20 percent and 40 percent, the Commission extend the accommodation provided in Rule 3-06 to the period included in post-acquisition results (that is, permit registrants to omit the pre-acquisition financial statements of the acquired business for the most recently completed fiscal year once the acquisition included in the audited results of the registrant for at least nine months).

Currently, the SEC staff permits registrants to reduce the number of periods for which historical financial statements of the acquired business are required by the equivalent period that the acquired business is included in the registrant's post-acquisition audited results, provided there is no gap between the pre-acquisition and post-acquisition periods. If, based on investor input, the Commission decides to require additional financial statements for businesses acquired prior to the most recently completed fiscal year for which the audited financial statements are required for the registrant, we recommend that the Commission permit a gap between audited pre-acquisition and post-acquisition periods to satisfy the S-X Rule 3-05 requirements if the acquired business has been included in the audited post-acquisition results for at least nine months. For example, if the registrant with a calendar year-end has consummated an acquisition that is significant at more than 40 percent in March 2018, it could satisfy the S-X Rule 3-05 requirements in its IPO registration statement, by including financial statements of the acquired business for the year ended December 31, 2017 only, provided the registration statement includes audited financial statements of the registrant for the year ended December 31, 2018.

Further, if the condition related to full fiscal year is retained, the Commission should consider clarifying how Proposed Rule 3-05(b)(iii) would be applied when the registrant has a change in fiscal year-end and the transition period is nine months or more.

Oil and gas producing activities

The proposed rule seeks to codify the interpretive guidance related to historical financial statements for interests in producing oil and gas properties. The proposal permits registrants to provide a statement of revenue and direct expenses, excluding depletion, depreciation and amortization, corporate overhead, interest, and taxes if the acquisition constitutes a business that includes "significant" oil and gas producing properties. We recommend that the Commission provide clarification on what constitutes "significant." Further, one of the conditions to qualify for this scaled disclosure requirement is that "substantially all" of the revenue of the business must be derived from oil and gas producing activities. We recommend that the Commission consider providing clarification on what constitutes "substantially all." Absent any clarification, we believe there would be diversity in practice.

Individually insignificant acquisitions

Pre-acquisition financial statements and pro forma information

If in aggregate the significance of individually insignificant acquisitions and significant acquisitions that are either probable or consummated, but for which financial statements are not yet required, exceeds 50 percent, the proposed rule would require a registrant to file the following:

- Pre-acquisition financial statements for the most recently completed fiscal year for those probable or consummated acquisitions that are individually significant; and
- Pro forma financial information depicting the aggregate effect of all acquisitions "in all material respects."

We support the Commission's proposal to not require financial statements for any acquisitions that are individually insignificant. However, we foresee certain challenges in the application of the proposed rule. The new requirements could potentially be more burdensome in certain instances. For example, the proposal requires registrants to include financial statements of all acquisitions that exceed 20 percent significance in a registration or proxy statement. Where a registrant acquires two businesses, one at 20 percent significance and the other at 40 percent significance, both of which are in the pendency period, under the proposed rule, the registrant would have to file the financial statements of both these businesses, whereas under the existing rules, financial statements are only required for the larger entity.

Further, we recommend that the Commission consider providing additional clarification on what "in all material respects" means. Registrants may have varying levels of information with respect to smaller acquisitions. Absent clarification in the rule on the expected disclosures, there could be diversity in the level of disclosures provided by registrants.

Comfort letters

PCAOB Auditing Standard 6101, *Letters for Underwriters and Certain Other Requesting Parties*, prohibits accountants from providing negative assurance on pro forma financial information if the underlying historical periods are not audited or reviewed. Where the registrant includes the effects of individually insignificant acquisitions for which underlying historical financial statements have not been audited or reviewed, the accountants would not be able to provide negative assurance on pro forma financial information prepared in accordance with S-X Article 11. It is possible that underwriters might request that the underlying information for such smaller acquisitions be audited or reviewed, which could increase the burden on the registrant and delay the offering.

Interaction between S-X Rule 3-05 and S-X Rule 3-14

As proposed, the aggregate impact determination for individually insignificant acquisitions in S-X Rule 3-05 would exclude acquired real estate operations subject to S-X Rule 3-14 and vice-versa. Since a registrant can have both types of acquisitions, we recommend the Commission consider including both in the aggregate impact determination. This would be consistent with the Commission's approach of aligning S-X Rule 3-14 with S-X Rule 3-05. We also encourage the Commission to provide guidance on how the aggregation would be performed, given the differences in the underlying tests for determining significance for business and real estate operations.

Pro forma financial information (S-X Article 11)

Adjustment criteria and presentation requirements

Management adjustments

With the objective of simplifying and clarifying pro forma requirements and adding more flexibility with respect to the type of pro forma adjustments allowed, the proposal would require inclusion of a column for management's adjustments, which would reflect synergies and other effects of the transaction that have occurred or are reasonably expected to occur and are reasonably estimable.

While we support the Commission's objective of providing information to investors related to synergies and other effects of the transaction, the requirements in the proposed rule seem overly broad, which could result in several implementation challenges, including, but not limited to the following:

- The proposed rule, if adopted in its current form, could result in varying degrees of forward-looking information. We believe that the proposal doesn't provide sufficient clarity on the nature of synergies and other effects of transactions that could be given effect to in the pro forma financial information. Further, there is no time limit prescribed in which such effects should be realized. This could result in significant diversity in the nature and type of pro forma adjustments with a potential of being based on unrealistic expectations, which could be misleading to investors.
- Whether synergies are reasonably likely to occur and whether the effects are reasonably estimable would require a registrant to exercise significant judgment, which could be time consuming and add costs and burdens on the registrant, especially in light of the limited time to prepare such information.
- Certain synergies that are expected to occur, such as closing certain facilities or employee terminations, may be preliminary at the time of filing the pro forma financial information and may not have been previously disclosed to investors. This may create further challenges for a registrant to provide such information in the pro forma financial information.

We recommend that the Commission provide specific implementation guidance related to management's adjustments.

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Further, the existing rules and interpretive guidance requires a registrant to adjust for income, expenses, gains, and losses that are related to the transaction and are factually supportable but do not have a continuing impact on the operations. The proposed rule would not allow for adjusting such nonrecurring items but rather for disclosing them in the footnotes to the pro forma financial information. We recommend that the Commission consider whether such adjustments can be allowed to be adjusted as part of the management adjustment column.

Comfort letters

PCAOB AS 6101 was drafted in the context of existing S-X Article 11 requirements. The proposed rule would significantly amend those rules and would introduce adjustments for forward-looking information that the registrant believes are likely expected to occur, which was not contemplated in the comfort letter standard. If the pro forma requirements are adopted as proposed, we encourage the Commission to perform outreach to the PCAOB to determine whether any changes to the comfort standard are warranted. Absent such changes, accountants would have to determine the level of assurance that can be provided on management adjustments. The auditors' conclusions on these matters could differ significantly based on facts and circumstances.

Investment companies, including business development companies

Applicability of S-X Rule 3-05

We recommend that the Commission clarify the circumstances under which an investment company would follow S-X Rule 3-05 for non-fund acquisitions. Footnote 222 of the proposed rule states that "In the event of a non-fund acquisition, investment companies would follow Rule 3-05." We presume that consistent with current practice, the reference to a non-fund acquisition would be limited to the circumstances described in ASC 946-810-45-3, where an investment company has an investment in an operating entity that provides services to an investment company, for example, an investment adviser or transfer agent. In those cases, the purpose of the investment is to provide services to the investment company rather than to realize a gain on the sale of the investment. We recommend that the Commission clarify the types of non-fund acquisitions that would require investment companies to follow S-X Rule 3-05.

Further, Proposed Rule 6-11 states that a fund acquisition "includes" the acquisition by the registrant of all or substantially all of the portfolio investments held by another fund or an acquisition of a fund's portfolio investments that will constitute all or substantially all of the initial assets of the registrant. We recommend that the Commission clarify that "fund acquisition," as defined in the proposed rule, is limited to acquisitions that result in the registrant including individual assets of the acquired fund in the registrant's portfolio, rather than when the registrant acquires an equity interest in another fund.

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We would be pleased to discuss our comments with you. If you have any questions, please contact Bert Fox, National Managing Partner of Professional Standards, at [redacted] or [redacted].

Sincerely,

/s/ Grant Thornton LLP