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Vanessa Countryman, Secretary
Security and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

SEC Release No. 34-85765; IC-33465; File No. S7-05-19
Amendments to Financial Disclosures about Acquired and Disposed Businesses

Dear Madam Secretary:

We appreciate the opportunity to respond to the Securities and Exchange Commission's (SEC or Commission) request for comments on the proposed rule, *Amendments to Financial Disclosures about Acquired and Disposed Businesses* (Proposed Rule or Proposal). As a firm involved in various aspects of financial reporting by public companies, and as the SEC points out in the Proposed Rule, KPMG LLP has observed situations where financial information that is not otherwise material to investors is required by applying the SEC's current rules and regulations. We generally agree with the proposed amendments that codify current practice as well as those intended to simplify the financial reporting requirements of acquired and disposed businesses. We believe that the Commission may be better able to achieve its objectives of easing the compliance burden on registrants and enhancing decision-useful information provided to investors by making some relatively simple revisions to Regulation S-X. Our suggestions and observations focus on, among other things:

- Enhancing the *significance tests*, specifically more closely aligning the measurement date of a registrant's aggregate worldwide market value to the transaction date (investment test) and retaining pre-tax net income (income test)
- Expanding the use of abbreviated financial statements in the *oil and gas* industry
- Reducing complexity in the proposed changes that permit reconciliation to International Financial Reporting Standards as issued by the International Accounting Standards Board for certain acquired *foreign businesses*
- Permitting post-acquisition financial statements reflecting an acquired business's results for a period of nine to twelve months to satisfy acquired business financial statement requirements in *initial registration statements*
- Clarifying terminology related to acquired *real estate operations*
- The nature and timing of *pro forma adjustments*, specifically related to management adjustments and potential constraints related to an auditor's ability to provide comfort to underwriters on these adjustments

- Clarifying the revised significance tests used by *investment companies* and certain financial reporting requirements applicable for fund and non-fund acquisitions as proposed in new Rule 6-11, and implications of the proposed changes to other Regulation S-X rules
- Updating *SEC staff guidance* to include only that which will be applicable under the final rule.
- Specifying the applicable *independence standards* for acquired businesses and the use of International Standards on Auditing for the audits of acquired foreign businesses
- Areas for which *transition guidance* would be useful for registrants upon the effective date of the final rule

Significance Tests

The significance tests[1] required by Rule 3-05 of Regulation S-X at times result in a registrant providing audited financial statements that may not be material to investors. On that basis, we support the objectives of the proposed amendments to better align the investment test with the economic significance of transactions and reduce incidents of otherwise insignificant acquisitions being deemed significant based on the extant income test. We offer the Commission the following perspectives on the proposed significance tests that we believe may yield higher quality financial information and elevate the final rule's achievement of such objectives.

Investment Test

We believe that the proposed use of a registrant's aggregate worldwide market value as the denominator in the investment test will provide a more meaningful comparison for determining overall significance of an acquisition to the registrant's business. However, we are not certain that determining the registrant's aggregate worldwide market value as of the last business day of the registrant's most recently completed fiscal year will yield a value that best reflects the registrant's current fair value. As the aggregate worldwide market value is often readily accessible to the registrant, we recommend that the Commission consider aligning the fair value measurement date of the registrant to be in closer proximity to the fair value measurement date of the acquired or disposed business. This would lead to more timely and relevant comparisons of the fair value of the involved companies. If the investment test is adopted as proposed, the timing of the data used to determine the registrant's fair value may be stale due to more recent developments (e.g., other transactions or events), and stock price movements (e.g., reactions to earnings releases or general market conditions). In certain instances, as proposed, the fair value used may be more than twelve months old.

Income Test

While amending the income test to use after-tax net income may provide simplification, we encourage the Commission to retain the current pre-tax net income metric. Income tax provisions

[1] SEC Regulation S-X, Rule 1-02(w)

often include significant unusual adjustments that do not have bearing on a comparison of the relative sizes of the entities and, in many cases, relate to events or transactions outside of the registrant's or acquired company's control. Common examples include the impacts of tax law changes in any of the relevant jurisdictions for either of the entities and changes in the valuation allowance for deferred tax assets. Depending on the direction of the income tax adjustment, the calculation of significance could be understated – and thereby reduce the information being provided to investors. Alternatively, the calculation of significance could be overstated – and thereby either result in undue cost for a registrant to provide disclosures of economically insignificant acquisitions or a new category of requests to the SEC staff for relief from using that measure. Moreover, different corporate structures may also have an exaggerated impact on the proposed income test and result in an entity appearing to be more significant to the acquirer than is appropriate. For example, if a taxable corporation purchases a pass-through entity, there would be a built-in bias of significance resulting from the comparison of inherently non-comparable data. The reverse would be true if a pass-through entity were to purchase a taxable entity.

Lastly, we recommend the Commission clarify the definition of 'recurring annual revenue' to prevent confusion or diversity in its application. We believe it may be unclear what revenues would be considered "recurring" from one period to the next. For example, in a situation where a registrant experiences an increase in sales orders from an existing customer it may be difficult to determine the reason for the increase. Consequently, determining whether that increase is one-time event or attributed to recurring annual revenue may be difficult.

Oil- and Gas-Producing Activities

Codifying current practice for businesses that have oil- and gas-producing activities will prove beneficial for registrants and investors. We encourage the Commission to also consider permitting the use of abbreviated financial statements for acquired businesses related to the servicing of the oil and gas fields – e.g., the acquisition of a midstream processing facility or storage facility. Currently, full financial statements are required for these types of acquisitions. Abbreviated financial statements would simplify reporting requirements for registrants while providing investors with relevant and meaningful information.

Foreign Businesses

Proposed Rule 3-05(c) permits an acquired or to-be acquired foreign business to prepare its financial statements without reconciliation to US generally accepted accounting principles (US GAAP) if (i) those financial statements were prepared in accordance with another comprehensive basis of accounting principles other than US GAAP or International Financial Reporting Standards as issued by the International Accounting Standards Board (IFRS-IASB) *and* reconciled to IFRS-IASB, and (ii) the registrant is a foreign private issuer using IFRS-IASB. We recommend that the Commission simplify the requirements of Rule 3-05 by extending this accommodation to an acquired or to-be acquired business that would be a foreign private issuer if it were a registrant, regardless of whether it met the definition of a foreign business; thereby eliminating Rule 3-05(d).

Initial Registration Statements

We support the Commission's proposal to no longer require pre-acquisition financial statements of an acquired business in an initial registration statement once the acquired business is reflected in the registrant's post-acquisition audited consolidated financial statements. The Proposal requires the operating results of the acquired business to be included in the registrant's post-acquisition results for a "complete fiscal year". We believe a registrant should be allowed to substitute a period of at least nine months to satisfy the full year requirement in this circumstance. Therefore, we recommend the Commission allow that financial statements of an acquired business need not be presented once the acquired operations are included in at least nine months of audited post-acquisition results in an initial registration statement.

Real Estate Operations

We agree with the Commissions efforts to align Rule 3-14 with Rule 3-05 where no unique industry considerations exist and believe this will help alleviate confusion that may exist in current practice.

The Commission's proposed definition in Rule 3-14(a)(2) uses the term 'business' (as set forth in 210.11-01(d)) whereas the definition of a business under U.S. GAAP generally excludes entities that generate substantially all of their revenues through the leasing of real property. In practice, we have observed this contradiction to be a source of confusion for registrants trying to apply the definition and ask the Commission to take this into consideration when finalizing the Proposal.

Pro Forma Financial Information

Management Adjustments

The introduction of Management Adjustments into pro forma financial information may assist investors by providing insight about management's expectations of how the transaction will affect its business. However, determining "reasonably estimable synergies and other transaction effects that have occurred or are reasonably expected to occur" (i.e., Management Adjustments) will require making estimates or assumptions, some of which may be significant. These adjustments further introduce judgment into the pro forma financial statements, potentially making them less consistent across companies and more difficult for investors to interpret. Inaccurate estimates may have an adverse impact on reporting and could mislead investors. The Proposal highlighted that the current pro forma adjustment criteria are unclear and often result in inconsistent application for similar fact patterns. The proposed changes appear open to interpretation and, if adopted as proposed, are at risk of leading to diversity or misapplication without more detailed guidelines. To avoid the Proposed Rule repeating the same challenges currently experienced, we recommend the Commission provide interpretative or implementation guidance.

- Within the guidance, we encourage the Commission to clarify the objective[2] of pro forma financial information under the Proposed Rule. We also believe registrants would benefit

[2]A clearly stated objective would enable registrants, investors, and auditors to have a better understanding of the intent and benefit of the disclosure requirements and therefore facilitate consistent application of the

from additional guidance that addresses the following specific to Management Adjustments: Define the criteria for the terms 'reasonably estimable' and 'reasonably expected to occur', including (i) acceptable measurement principles, (ii) acceptable timeframes the synergies may be expected to or must occur, (iii) the probability to be considered while making this determination, and (iv) what to do if there is a range of outcomes.

- Expand the examples of synergies to include not only cost saving synergies but also revenue-related synergies. Additionally, examples of Management Adjustments that are and are not appropriate could be added, such as differentiating between a forward-looking adjustment and a projection or forecast. The Commission could also include expectations about including both positive and negative effects within these adjustments.
- Clarify or illustrate the timing for when adjustments are reflected in the balance sheet versus the income statement.
- Clarify whether and how the estimates and assumptions used to determine Management Adjustments may need to be revised in subsequent filings when pro forma financial information must be updated to satisfy updating requirements.

Further, we believe investors should be clearly informed that the Management Adjustments are hypothetical synergies that may not be achieved by management. We request the Commission to consider requiring qualitative disclosures that include language to this effect.

Lastly, the proposed changes further diverge pro forma financial information between Article 11 and ASC 805, Business Combinations. These differences may confuse investors supporting the suggestion above to clarify the objective of Article 11.

Auditor Involvement

PCAOB Auditing Standards 6101, Letters for Underwriters and Certain Other Requesting Parties, does not currently address whether or at what level an auditor may provide comfort to underwriters on Management Adjustments as proposed. We recommend the Commission consider feedback from investors and underwriters on the level of auditor involvement they require and collaborate with the PCAOB to discuss whether, and if so what, revisions must be made to current auditing standards. Because rulemaking of this nature could take an extensive amount of time, we encourage the Commission to contemplate, with consideration given to the feedback received from market participants, relocating the presentation and discussion of Management Adjustments to another section of the filing (e.g., Management's Discussion and Analysis) either permanently or until the auditing standard is updated. Alternatively, separately presenting and summing the Management Adjustments in the final total pro forma column may provide enough of a distinction if feedback indicates auditor involvement is not necessary. Auditors would continue to be able to provide some level of comfort on the financial information included in the subtotal of the historical financial statements and Transaction

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requirements. If the objective of Article 11 is deleted as proposed in footnote 178 of the Proposal, we believe it is important that the objective be clarified within interpretative or implementation guidance.

Adjustments so long as the historical financial statements that serve as the basis for the pro forma financial information have been reviewed or audited.

Investment Companies

Significance Tests

We generally support the proposed amendments to the significant subsidiary tests for investment companies; however, we believe there are certain areas that require clarification or further amendments.

The proposed income test for investment companies uses the absolute value of the combined investment income from dividends, interest, and other income, the net realized gains and losses on investments, and the net change in unrealized gains and losses on investments from the tested subsidiary. Certain aspects of this calculation are unclear. In the proposed income test, the numerator is the absolute value “from the tested subsidiary”. It is unclear whether this amount should be calculated at the registrant level (using the portion of the registrant’s components of income that are attributed to the tested subsidiary) or whether the numerator should be calculated at the subsidiary level (using the tested subsidiary’s components of income). We believe a calculation at the registrant level would better measure significance as it would only include income that had an impact to the registrant. For example, when performing the income test, we believe the registrant should use its income generated from the investment in the subsidiary rather than looking directly through the subsidiary and using the subsidiary’s income generated by the subsidiary’s operations. This would allow the income test to be more applicable to subsidiaries that are either investment companies or non-investment companies

On the other hand, if the numerator is calculated at the subsidiary level, it is unclear how investment companies would apply the income test to subsidiaries that are non-investment companies. The Proposed Rule notes that the asset test becomes less meaningful due to the comparison between assets of non-investment companies generally based upon historical cost and assets of investment companies based on market price or fair value. We would note a similar observation for the income test if the numerator was calculated at the subsidiary level for non-investment companies due to a lack of comparability between the components of net income reported by non-investment companies with the components required to be reported by investment companies under Rule 6-07 of Regulation S-X.

It is also unclear whether the numerator in the income test should be calculated by (1) combining each of the components first, and then using the absolute value of the combined amount, or (2) combining the separate absolute values of each of the components. We believe the income test should be based upon combining each of the components first before determining the absolute value, as there may be double counting of components if the latter method was used. For example, if an investment with significant unrealized appreciation in value in prior years was sold in the current year, an investment company would record the realized gain in the current year, but also have a corresponding change in unrealized loss for the portion of the appreciation in value recorded in prior years. If the absolute value was determined first, the same prior year unrealized appreciation in value of that investment would be double counted. Also, by combining each of the components first, we believe it will better measure the income test since it will effectively eliminate the impact of prior year unrealized appreciation in value in the current year calculation.

The Proposal notes that, as with non-investment companies, the income test may indicate significance even though the tested subsidiary represents a very small component of the registrant's investment portfolio. However, income for an investment company may result from investments that either are no longer held by the investment company or that have significantly depreciated in value. As a result, we support the proposed alternate income test, however we believe that this should be the primary income test. We believe that the current proposed 80% test would not effectively measure significance since it does not contain an investment test component.

We support using five-year income averaging for investment companies as income for certain investment companies can fluctuate widely from year to year. However, we believe that further clarification is necessary in determining what constitutes an "insignificant" change in net assets resulting from operations and suggest a 10% threshold be used similar to that proposed to be used for the income test of operating companies when the proposed revenue component does not apply. We also believe it is not clear in the Proposal on whether five-year income averaging is permitted or required, but we believe it should not be required as there may be instances where five-year income averaging results in a measurement that is not reflective of current operations.

Proposed Rule 6-11 of Regulation S-X

We support Proposed Rule 6-11 of Regulation S-X, however the continued applicability of Rule 3-05 of Regulation S-X is not clear for investment companies. Footnote 222 of the Proposal states that investment companies should follow Rule 3-05 for non-fund acquisitions. We recommend that the final rule clarify the specific types of non-fund acquisitions intended with the statement in this footnote as well as provide further clarification that Rule 6-11 is intended to be in lieu of Rule 3-05 for fund acquisitions.

In regards to the inclusion of the Article 12 schedules for a private fund, we recommend that these schedules be permitted to be unaudited with a reconciliation to the condensed schedule of investments contained within the audited financial statements. We believe there will be situations in which the auditor of a private fund will not be able to reissue the audited financial statements with the Article 12 schedules due to independence or other reasons.

Proposed Rule 6-11 states that the determination of whether a fund has been acquired or will be acquired should be evaluated in light of the facts and circumstances and lists two circumstances in which a fund acquisition has occurred – the acquisition by the registrant of all or substantially all of the investments held by another fund, or the acquisition of a fund's portfolio that will constitute all or substantially all of the initial assets of the registrant. However, it is unclear whether there are other circumstances that should be considered to be a fund acquisition and what criteria should be considered. For example, it is unclear how proposed Rule 6-11 would be applied for a fund that has been acquired in the aggregate by a group of related funds.

Proposed Rule 6-11 states that a fund acquisition includes the acquisition of a fund's portfolio investments that will constitute substantially all of the initial assets of the registrant. We believe there are situations in which the assets acquired will represent substantially all of the initial assets of the registrant, but the assets acquired will only represent a portion of the acquired fund's assets. In those situations the full financial statements of the acquired fund may not be meaningful. We recommend that the final rule clarify the circumstances in which carve-out financial statements (or stand-alone schedule of investments) may be provided in lieu of the full financial statements of the acquired fund.

Rules 3-09 and 4-08(g) of Regulation S-X for Investment Companies

The Proposed Rule notes that the changes to the significant subsidiary definition would have effects on investment company application of Rule 3-09 regarding separate financial statements for significant subsidiaries and Rule 4-08(g) regarding summarized financial statements information of subsidiaries not consolidated. However, we believe there should be further amendments to Rule 3-09 to incorporate changes to the proposed amendments to the significant subsidiary tests for investments companies, including the proposed alternate income test. Similar to substituting 20% for 10%, we believe that Rule 3-09 should be amended to substitute 10% for 5% in the proposed alternate income test.

We also recommend that the final rule include further amendments to Article 6 of Regulation S-X to incorporate the application of Rule 3-09 and Rule 4-08(g) to non-fund subsidiaries and joint ventures, including the definition of control. We believe that in most instances, financial information of investees may not be necessary as neither the operating results nor the financial condition of an investee are directly included in the investment company's financial statements. However, we recognize there could be instances when certain financial information for investees of investment companies may be useful to investors.

SEC Staff Guidance

The Proposed Rule, while largely codifying current practice and simplifying the financial reporting requirements, will have a pervasive impact to the extensive guidance that the SEC staff have provided on Rules 3-05, 3-14, and Article 11. To mitigate any confusion or misapplication of a final rule, we stress the importance for the staff to undertake a comprehensive review of the guidance currently in circulation and update or eliminate such guidance that will not be applicable under the final rule. Similar to the current announcements on periodic updates to the Financial Reporting Manual, we recommend releasing a summary of *all* changes to existing guidance concurrent with the release of the final rule.

Independence Standards

We are supportive of proposed Rule 3-05(a)(1) and conforming changes to Rules 3-14 and 6-11 that clarify "this regulation" includes the independence standards in Rule 210.2-01. To avoid confusion or diversity in application of the general phrase "applicable independence standards", we recommend that the Commission specify the independence standards would be those applicable under the auditing standards used to perform the audit of the acquired or to be acquired business. For example, if the required financial statements in accordance with this regulation were audited under AICPA standards, the AICPA independence standards would apply. Under current requirements this would clarify for registrants, that the independence standards of the PCAOB or AICPA would apply in situations where the business is not a registrant.

We also recommend that the Commission permit an audit of financial statements of a foreign acquiree filed for purposes of Rule 3-05 to be performed in accordance with International Standards on Auditing (ISAs). We see this as an opportunity for the Commission to achieve its objective of reducing burdens on registrants while maintaining investor protection. ISAs are largely converged with AICPA standards and widely accepted worldwide. In many situations, financial statements of a foreign acquiree audited in accordance with ISAs are readily available. By accepting audits performed in accordance with the ISAs in this situation, a registrant would not incur additional time and costs to obtain an audit performed using generally accepted auditing standards in the US. Therefore, we recommend the Commission consider permitting ISAs for audits of acquired foreign businesses for Rule 3-05 purposes. If the SEC plans to consider accepting ISAs in the future or in connection with this proposal, we believe the independence language recommended above would accommodate this situation.

Transition Guidance

Because acquisitions and dispositions are continually occurring in the marketplace, a final rule will affect registrants that are in the process of consummating an acquisition or disposal as well as those contemplating a future acquisition or disposal of a business. Therefore, we recommend that the Commission provide transition guidance that clarifies the effective date, including permissibility of early application of the amendments and application of the rule to transactions consummated near the final rule's effective date.

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We appreciate the opportunity to respond to the request for comments on the Proposed Rule. If you have any questions regarding our comments or other information included in this letter, please do not hesitate to contact Jeffrey Jones [redacted] or [redacted]) or Timothy Brown ([redacted] or [redacted]).

Very truly yours,

KPMG LLP

cc:

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