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July 29, 2019

By email: rule-comments@sec.govU.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549**Re: Amendments to Financial Disclosures about Acquired and Disposed Businesses; File Number S7-05-19**

Dear Office of the Secretary:

The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high-quality performance by public company auditors; convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention; and advocates policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, DC, the CAQ is affiliated with the American Institute of CPAs (AICPA). This letter represents the observations of the CAQ SEC Regulations Committee and, with respect to Section IX only, the AICPA Investment Company Expert Panel, but not necessarily the views of any specific firm, individual, or CAQ Governing Board member. The CAQ appreciates the opportunity to share our views and provide input on the Securities and Exchange Commission's ("Commission" or "SEC") Proposed Rule, *Amendments to Financial Disclosures about Acquired and Disposed Businesses* (the "proposal" or the "Proposed Rule").¹

Since auditors serve an important role in enhancing the quality and reliability of certain financial information disclosed in Commission filings, the profession has a strong interest in the success of the Commission's efforts. Therefore, we provide our comments through the lens of the public company audit profession. We also highlight potential improvements to the proposal that may help the SEC achieve its objective more effectively and enable registrants and auditors to avoid unnecessary challenges when applying the rules in practice. Our comments are organized into the following sections:

- I. Overall Objective of the Proposed Rule
- II. Significance Tests
- III. Abbreviated Financial Statements
- IV. Independence
- V. Foreign Businesses
- VI. Registration Statements
- VII. Financial Statements of Real Estate Operations Acquired or to be Acquired

¹ [Amendments to Financial Disclosures about Acquired and Disposed Businesses, 33-10635; 34-8576](#); File No. S7-05-19.

- VIII. Pro Forma Financial Information
- IX. Investment Company Considerations
- X. SEC Staff Guidance

I. Overall Objective of the Proposed Rule

The CAQ supports the overall objective of the Proposed Rule to “improve for investors the financial information about acquired or disposed businesses, facilitate more timely access to capital, and reduce the complexity and costs to prepare the disclosure.” We also generally support the provisions of the Proposed Rule because we believe they will achieve the Commission’s objective. We also appreciate the Commission’s thoughtful consideration of the input provided in our [November 25, 2015 comment letter responding to the Commission’s Request for Comment on the Effectiveness of Financial Disclosures about Entities Other than the Registrant](#) as it formulated the Proposed Rule.

II. Significance Tests

The Commission states that Proposed Rule 1-02(w)(1)(iii)(A)(1) would “simplify the calculation of the net income component” of the income test by using income or loss from continuing operations *after* income taxes. We acknowledge that using after-tax amounts may simplify the determination of income from continuing operations by permitting a registrant to use line item disclosures from its financial statements. However, we believe the use of after-tax income may result in significance determinations that are less consistent and meaningful than those made today. For example, a pass-through entity could appear to be more significant to a registrant under the proposed test than an identical business that pays income taxes. We also note that income taxes can be volatile for reasons unrelated to a company’s operations (e.g., changes in tax law, changes in valuation allowances) and this volatility could distort the results of the test. We recommend that the Commission continue to require registrants to test significance using pretax results because it is more likely to provide a consistent measure of relative significance that is unaffected by tax characteristics or income statement volatility related to taxes.

We also recommend more closely aligning the measurement date for the worldwide market value of common equity of the registrant in the investment test in Proposed Rule 1-02(w)(1)(i) to the measurement date of the fair value of the purchase or sale consideration. This could be accomplished, for example, by requiring registrants to determine worldwide market value on the last business day prior to the public announcement of the transaction rather than on the last business day of the most recently completed fiscal year. A more recent date would lead to a more meaningful test because events impacting the worldwide market value of the registrant (e.g., additional completed fiscal periods, additional acquisitions or dispositions) might have occurred since the most recently completed fiscal year.

In an initial public offering (IPO), we recommend allowing a company to estimate its worldwide market value at the anticipated offering date for the investment significance test under Proposed Rule 1-02(w)(1)(i). An estimate of public float, which is a portion of estimated worldwide market value, already is used by an IPO candidate seeking to take advantage of the scaled disclosure accommodations available to smaller reporting companies. We believe this would align better the investment test for an IPO candidate to an existing registrant.

We also recommend that the Commission define the new term “recurring annual revenue” to ensure consistent application of the income significance tests.

III. Abbreviated Financial Statements

Currently, registrants frequently request relief from the SEC staff to provide audited statements of assets acquired and liabilities assumed and of revenues and expenses (collectively, “abbreviated financial statements”) in lieu of the complete financial statements required by Regulation S-X Rule 3-05 (Rule 3-05). The Proposed Rule seeks to codify the SEC staff’s current approach to evaluating these requests and would reduce the need for registrants to make them (and the staff to use its limited resources to respond). We believe codification of the SEC staff’s approach will facilitate more timely access to the capital markets and reduce the burden associated with requesting relief.

In order to assist registrants in determining whether their facts and circumstances allow for providing abbreviated financial statements, we recommend clarifying the proposed criteria. These clarifications would reduce the inappropriate usage of abbreviated financial statements in lieu of full financial statements and avoid situations where the substance of transactions is similar, but the financial reporting outcomes are different. For example, we recommend the Commission consider defining terms such as *separate entity*, *subsidiary*, *segment*, or *division* in the context of an acquired business, including whether the aggregation of multiple separate entities, subsidiaries, segments, or divisions would meet the criteria to permit abbreviated financial statements.

We also recommend that the Commission clarify when providing carve-out financial statements of an acquired business would be appropriate. Currently, the staff accepts these financial statements “if it is impracticable to prepare the full financial statements required by Regulation S-X.”² However, the Proposed Rule makes no mention of carve-out financial statements and as such it is unclear whether the Commission intends to change current practice.

IV. Independence

Proposed Rules 3-05, Rule 3-14 and Rule 6-11 would require financial statements to be “prepared and audited in accordance with this regulation.” Consistent with current practice, these rules also would clarify that references to “this regulation” include the independence standards in Regulation S-X Rule 2-01 unless the business is not a registrant, in which case the applicable independence standards would apply. We recommend that the Commission state in the final rules that the independence standards to be applied should be those related to the auditing standards under which the required financial statements of the acquired or to-be-acquired business were audited. This will avoid confusion or diversity in application of the general phrase “applicable independence standards.”

V. Foreign Businesses

The financial statement requirements applicable to an acquired or to-be acquired foreign business³ in Proposed Rule 3-05(c) differ from those in Proposed Rule 3-05(d) that are applicable to a business that would be a foreign private issuer if it were a registrant. We recommend that the Commission consider simplifying these rules by making the requirements in Proposed Rule 3-05(c) applicable to a business that would be a foreign private issuer if it were a registrant and eliminating Proposed Rule 3-05(d).

² See Sections 2065.3 of the Division of Corporation Finance’s Financial Reporting Manual (FRM).

³ See 17 CFR 210.4-01.

VI. Registration Statements

A. Omission of Rule 3-05 Financial Statements for Businesses That Have Been Included in the Registrant's Financial Statements

In connection with initial registration statements, the Proposed Rule would allow a registrant to omit pre-acquisition financial statements for acquisitions that have been included in its post-acquisition audited results for at least a “complete fiscal year” (12 months). Currently, a registrant can omit pre-acquisition financial statements of an acquired business that is at least 20 percent, but not more than 40 percent significant, if the business has been included in its post-acquisition audited results for at least nine months. We recommend that the Commission consider revising the Proposed Rule to allow registrants, including IPO candidates, to continue to omit these pre-acquisition financial statements.

B. Individually Insignificant Acquisitions

We believe that the Commission should be aware that underwriters may request the underlying information for insignificant acquisitions included in pro forma financial information be audited or reviewed, which could impose additional burdens on the registrant and delay access to the capital markets. Public Company Accounting Oversight Board (PCAOB) Auditing Standard 6101, *Letters for Underwriters and Certain Other Requesting Parties (AS 6101)*, prohibits accountants from providing negative assurance on pro forma financial information if the underlying historical periods for each entity included in the pro forma financial information are not audited or reviewed. Where the registrant includes the effects of individually insignificant acquisitions for which historical financial statements have not been audited or reviewed, the accountants may not be able to provide negative assurance on the combined pro forma information prepared in accordance with Regulation S-X Article 11.

VII. Financial Statements of Real Estate Operations Acquired or to be Acquired

We believe the Commission should consider extending the use of the proposed significance tests applicable to blind pool real estate offerings to blind pool offerings in which the acquisitions are within the scope of Rule 3-05 (e.g., blind pool offerings involving the acquisition of hotels). The reasons provided by the Commission for adapting the significance tests for blind pool real estate offerings would also apply to other blind pool offerings due to their similarity.

Additionally, proposed Regulation S-X Rule 3-14(c)(2)(iii) requires information about a real estate operation's “operating, investing, and financing cash flows, to the extent available.” As Regulation S-X Rule 3-14 financial statements consist only of statements of revenues and expenses, which exclude expenses not comparable to the proposed future operations (e.g., mortgage interest, depreciation, corporate overhead, etc.), it is not clear why incremental historical cash flow information that also may not be consistent with the proposed future operations would be required.

VIII. Pro Forma Financial Information

A. Management's Adjustments

The Proposed Rule introduces management's adjustments (MAs), a new category of pro forma adjustments that would provide flexibility to include forward-looking information depicting “reasonably estimable synergies and other transaction effects...that have

occurred or are reasonably expected to occur.” We believe MAs would allow for greater flexibility with respect to the types of pro forma adjustments that are required. Investors may benefit from insights into the potential effects of the acquisition and the post-acquisition actions expected to be taken by management. However, the description of MAs provided in the Proposed Rule may be overly broad and difficult to apply without further interpretive guidance. For example, preparers may believe MAs offer an opportunity to provide forecasted information, which may be inconsistent with the Commission’s intent and is already addressed in Rule 11-03 of Regulation S-X. Moreover, while we believe the Proposed Rule would provide greater consistency for similar fact patterns through the separate subtotal column that includes the transaction accounting adjustments,⁴ the level of subjectivity involved in determining whether MAs are required may reduce consistency of pro forma presentations as a whole.

In order to minimize potential inconsistencies, we believe the Commission should consider providing implementation guidance to clarify the requirements surrounding MAs and ensure consistency in their application. Specifically, we recommend that the Commission consider providing more explicit guidance as to the nature of MAs that may or may not be allowed. Such guidance could include illustrative examples similar to those provided in Regulation S-X Rule 11-02(b)(3) of the Proposed Rule, and could be provided in the rule itself, the adopting release or separate interpretive guidance.

Implementation guidance could, for example, clarify the following:

- *Synergies and other transaction effects* – The Proposed Rule identifies four examples of synergies and other transaction effects: (1) closing facilities, (2) discontinuing product lines, (3) terminating employees, and (4) executing new or modifying existing agreements. However, registrants may benefit from a discussion of other examples that may or may not be appropriate MA adjustments, including revenue-related synergies.
- *Non-recurring items* – The Proposed Rule eliminates the existing “continuing impact” criterion and instead requires disclosures of revenues, expenses, gains and losses which will not recur in the income of the registrant beyond 12 months after the transaction. Consider clarifying whether nonrecurring items necessary to achieve identified synergies would be included in the pro forma statement of comprehensive income and disclosed in the explanatory notes (e.g., one-time severance costs to achieve a recurring decrease in compensation expense).
- *Reasonably estimable* – Consider clarifying (1) what criteria should be met for an MA to be “reasonably estimable” and (2) if a range of reasonably estimable synergies and other transaction effects would qualify, what amount within the range should be used.
- *Reasonably expected to occur* – Consider clarifying whether there would be a limit on when the synergies and other transaction effects must occur (e.g., within 12 months of consummation).
- *Fair and balanced presentation* – The Proposed Rule indicates that qualitative information necessary to give a “fair and balanced” presentation of the pro forma financial information is required for each MA as well as synergies and other transaction effects that are not reasonably estimable. Registrants may benefit from further clarification of the nature of these expected disclosures.

⁴ Rule 11-02(a)(7) of the Proposed Rule

- *Pro forma balance sheet* – Consider clarifying the relationship between MAs on the pro forma statements of comprehensive income and the pro forma balance sheet. For example, the proposal is not clear regarding (1) when a MA may be appropriate to include in the pro forma balance sheet; or (2) the date on which the MA should be assumed to have occurred.

B. Consistency with U.S. GAAP

While U.S. Generally Accepted Accounting Principles (GAAP) (Accounting Standards Codification (ASC) 805-10-50-2(h)) and Article 11 both require disclosure of pro forma financial information, the requirements under each differ. ASC 805, *Business Combinations*, provides limited guidance about the presentation and preparation of pro forma information. As a result, to the extent ASC 805 is silent with regard to specific requirements, registrants preparing pro forma financial information under ASC 805 typically analogize to the requirements in Article 11. Before the Commission finalizes its proposed changes to Article 11, it should consider coordinating with the Financial Accounting Standards Board (FASB) as it relates to the FASB's expectations about how the proposed changes might impact the preparation of pro forma financial information under ASC 805. If the FASB concludes that the changes do not impact the pro forma information provided in accordance with ASC 805, the Commission should consider the resulting possibility that Article 11 and ASC 805, which are generally intended to achieve similar objectives, could diverge even further.

C. Comfort Letter Considerations

Underwriters typically request the auditor's involvement as part of the underwriters' due diligence responsibilities in a securities offering. If pro forma information is presented, a registrant's auditor is generally requested to provide negative assurance in a comfort letter on the application of pro forma adjustments to historical amounts in the compilation of pro forma financial information, and whether the pro forma financial information complies as to form in all material respects with the applicable accounting requirements of Rule 11-02 of Regulation S-X. The Proposed Rule introduces a new framework for pro forma financial information that will significantly change the manner in which pro forma financial information is presented, particularly with respect to MAs that may be subjective and involve significant management judgement. Given the fact that AS 6101 contemplates the existing pro forma requirements in Article 11, the Commission should consider coordinating with the PCAOB to determine whether such standards continue to be appropriate in light of the proposed changes or whether they should be revised and updated to contemplate the proposed requirements. If revisions or updates are deemed appropriate, transition guidance should be provided to assist practitioners until the standards are revised.

IX. Investment Company Considerations

We support the Commission's objective of tailoring the financial reporting requirements for investment companies with respect to acquisitions of investment companies and other types of funds. However, we recommend that the Commission make the clarifications described below to avoid unintended consequences and additional costs for investment company registrants.

A. Applicability of Rule 3-05 to Investment Companies for Non-Fund Acquisitions

We recommend that the Commission clarify the circumstances under which an investment company would follow Rule 3-05 for non-fund acquisitions. It is our understanding that an investment company would follow Rule 3-05 only for an acquisition of an operating company service provider that it would be required to consolidate or account for using the equity method of accounting pursuant to ASC 946-810-45-3 or ASC 946-323-45-2, respectively. However, footnote 222 to the Proposed Rule states that “In the event of a non-fund acquisition, investment companies would follow Rule 3-05.”

B. Proposed Rule 1-02(w)(2)(ii) – Income Test

- *Proposed Rule 1-02(w)(2)(ii) - Numerator:*

We recommend that the Commission clarify whether the numerator for the tested subsidiary should be calculated as either (1) the absolute value of the sum of 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 (Method 1) or (2) the sum of the individual absolute values of each of these components (Method 2).

Example:

Investment income	\$12	
Net realized gain/loss on investments		(9)
Net change in unrealized gain/loss on investments		<u>(5)</u>
Method 1 Numerator		\$2
Method 2 Numerator		\$26

Page 176 of the Proposed Rule (in the text of the proposed amendments) appears to imply an investment company would use Method 1 while page 101 might imply an investment company would use Method 2. We believe the numerator should be calculated using Method 1, because if Method 2 were used, there could be a double counting of realized and change in unrealized gains and losses on investments. For example, if an investment with a prior year cumulative unrealized appreciation of \$10 was sold in the current year, under Method 2, the entry to reclassify the cumulative unrealized appreciation of \$10 to realized gain would result in the double counting the absolute values of the resulting realized gain of \$10 and the change in unrealized loss of \$10. Further, this result could be disproportionate to the total net change in value in the current year.

- *Proposed Rule 1-02(w)(2)(ii)(B) – Five-Year Income Averaging Alternative:*

Meaning of “Insignificant”

The Proposed Rule provides an alternative measure for the denominator in the income test which is to use the average of the absolute value of the changes in net assets resulting from operations for the registrant and its consolidated subsidiaries for each of its last five fiscal years when the change in net assets resulting from operations for the most recently completed fiscal year is “insignificant” (Five-Year Income Averaging). We agree that the Commission should permit an alternative calculation measure for the denominator, as an insignificant change for a recently

completed year could potentially have unintended consequences on the proposed income test for investment companies. However, we recommend the Commission provide clarity on what constitutes an “insignificant” change in net assets resulting from operations. Without clearly defining what constitutes “insignificant,” there could be differences in interpretation and ultimately diversity in what is deemed to be a significant subsidiary from one registrant to another.

Accordingly, we recommend the Commission require five-year income averaging if the absolute value of the change in net assets resulting from operations of an investment company registrant and its subsidiaries consolidated is at least 10 percent lower than the average of the absolute value of such amounts for each of its last five fiscal years.

Whether Five-Year Income Averaging is Permitted for 1-02(w)(2)(ii)(A)

The reason provided by the Commission for permitting the use of Five-Year Income Averaging by investment companies is “to further mitigate the potential adverse effects of the proposed income test for investment companies with insignificant changes in net assets resulting from operations for the most recently completed fiscal year.” However, Five-Year Income Averaging is only included in the alternate income test in Proposed Rule 1-02(w)(2)(ii)(B) but is not included in the 80 percent income test in Proposed Rule 1-02(w)(2)(ii)(A). As the rationale above would apply to both of the Proposed Rules, it is not clear whether this difference was intentional. We recommend the Commission clarify whether an investment company is permitted to use Five-Year Income Averaging in the 80 percent income test.

C. Proposed Rule 6-11 – Financial Statements of Funds Acquired or to be Acquired

Proposed Rule 6-11(a)(2)(ii) would require investment companies to evaluate whether a fund has been acquired or will be acquired based on facts and circumstances. Specifically, it indicates “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” (*emphasis added*).

The Commission’s use of the term “includes” could result in an overly broad interpretation of when the Proposed Rule might apply. For example, the Proposed Rule might technically apply whenever a fund of funds invests in an underlying fund as part of its investment strategy or when a fund invests in a money market fund or a business development company in the ordinary course of business. As such, we believe the Commission should use the term “is” in the rule text instead of the term “includes.”

X. SEC Staff Guidance

Existing staff guidance regarding financial disclosures about acquired and disposed businesses includes numerous interpretations, exceptions, and additional requirements that are not reflected in the current rules. We recommend that the SEC staff undertake a comprehensive review of this extensive guidance (e.g., in the FRM) and clarify which aspects will continue to apply and, if so, how they will apply in the context of any final rules. While it would be clear that certain existing staff guidance will no longer apply (because it has been addressed in the final rules, assuming the proposal is adopted as proposed), it would not be

clear for a significant portion of remaining guidance found across multiple chapters within the FRM. Providing this clarity prior to the effective date of any final rules in this area would likely reduce uncertainty and thus implementation time.

* * *

We appreciate the opportunity to comment on the questions raised in the proposal. As the staff and Commission gather feedback from preparers, users, and other interested parties, we would be pleased to discuss our comments or answer any questions that the staff or Commissioners may have regarding the views expressed in this letter. Please address questions regarding Sections I through VIII and Section X to Annette Schumacher (████████████████████); questions regarding Section IX should be addressed to Irina Portnoy (████████████████████).

Sincerely,



Julie Bell Lindsay
Executive Director
Center for Audit Quality

cc:

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