SEC Comments and Trends

An analysis of current reporting issues

September 2015
Every year, we closely monitor the Securities and Exchange Commission (SEC) staff’s comments on public company filings to provide you with insights on its areas of focus. Understanding the SEC staff’s comments and trends can help you as you head into the year-end reporting season. However, each registrant’s facts and circumstances are different and require judgments about the appropriate accounting treatment and evaluations about materiality. Therefore, while this publication highlights areas where the SEC staff may comment, registrants should carefully consider their disclosures based on whether the information is material to investors.

The SEC continues to encourage registrants to streamline disclosures and make them more meaningful. SEC Chair Mary Jo White has said the SEC’s disclosure effectiveness project is a priority and has directed the SEC staff to undertake a comprehensive review of disclosure requirements and recommend changes. In light of this initiative, registrants should consider the following points when evaluating the trends in staff comments we highlight in this publication and whether to adjust their disclosures:

- The SEC staff often issues comments to obtain additional information when it believes that a company may not have complied with requirements or the information may be material to investors. That does not mean the staff has not reached a conclusion that the requested information is material. Registrants should consider the materiality of additional disclosures before including them solely to clear an SEC staff comment.

- Registrants should regularly evaluate whether their disclosures continue to be material to investors as their facts and circumstances change. That is, they may eliminate immaterial disclosures even if they were included in prior filings in response to an SEC staff comment.

- Registrants should improve their disclosures by eliminating repetition and focusing on more meaningful discussion. For example, management’s discussion and analysis (MD&A) disclosure of critical accounting estimates often repeats disclosure from the significant accounting policies footnote without providing additional insight into the judgments and uncertainties underlying management’s estimates.

You can use this publication to identify topics where the SEC staff may challenge the accounting treatment or request enhanced disclosure. In all cases, we encourage companies to include a disclosure only when it is material to users.

The SEC staff continues to focus on many of the same topics that we highlighted last year. The following chart summarizes the top 10 most frequent comment areas in the current and previous years.
To our clients and other friends

<table>
<thead>
<tr>
<th>Comment area</th>
<th>Ranking 12 months ended 30 June</th>
<th>Comments as % of total registrants that received comment letters*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management’s discussion and analysis**</td>
<td>1</td>
<td>44%</td>
</tr>
<tr>
<td>Fair value measurements***</td>
<td>2</td>
<td>21%</td>
</tr>
<tr>
<td>Revenue recognition</td>
<td>3</td>
<td>16%</td>
</tr>
<tr>
<td>Non-GAAP financial measures</td>
<td>4</td>
<td>15%</td>
</tr>
<tr>
<td>Signatures, exhibits and agreements</td>
<td>5</td>
<td>16%</td>
</tr>
<tr>
<td>Income taxes</td>
<td>6</td>
<td>14%</td>
</tr>
<tr>
<td>Segment reporting</td>
<td>7</td>
<td>12%</td>
</tr>
<tr>
<td>Intangible assets and goodwill</td>
<td>8</td>
<td>12%</td>
</tr>
<tr>
<td>Acquisitions and business combinations</td>
<td>9</td>
<td>11%</td>
</tr>
<tr>
<td>Executive compensation disclosures</td>
<td>10</td>
<td>12%</td>
</tr>
</tbody>
</table>

* Based on comment letter topics assigned by research firm Audit Analytics for SEC comment letters issued to registrants related to Forms 10-K from 1 July 2013 through 30 June 2015

** This category includes comments on MD&A topics, in order of frequency: (1) results of operations (25%), (2) liquidity matters (15%), (3) business overview (11%), (4) critical accounting policies and estimates (10%) and (5) contractual obligations (2%). Many companies received MD&A comments in more than one category.

*** This category includes SEC staff comments on fair value measurements under Accounting Standards Codification (ASC) 820 as well as fair value estimates, such as those related to revenue recognition, stock compensation and goodwill impairment analyses. Individual SEC staff comments may be associated with more than one comment area in this chart.

The SEC staff continues to question registrants’ disclosures related to significant judgments and estimates, including those related to segment reporting, goodwill impairment, income taxes and revenue recognition. Registrants are spending significant time addressing SEC staff comments on these topics. The SEC staff requests additional information to support registrants’ conclusions and additional disclosures about the facts and circumstances that support significant judgments.

The main section of this publication discusses recent matters that concern all registrants. Appendices A, B and C highlight emerging trends related to specific industries, companies filing initial public offering (IPO) registration statements and foreign private issuers, respectively. Appendix D provides an overview of the SEC staff’s filing review process and best practices for responding to staff comments.

We hope you find this publication helpful. EY professionals are prepared to discuss any concerns or questions you may have.
<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oil and gas supplement</td>
<td>100</td>
</tr>
<tr>
<td>Real estate supplement</td>
<td>106</td>
</tr>
<tr>
<td>Retail and consumer products supplement</td>
<td>113</td>
</tr>
<tr>
<td>Technology supplement</td>
<td>118</td>
</tr>
<tr>
<td>Appendix B: IPO supplement</td>
<td>123</td>
</tr>
<tr>
<td>Appendix C: Foreign private issuers</td>
<td>130</td>
</tr>
<tr>
<td>Appendix D: SEC review process and best practices</td>
<td>135</td>
</tr>
<tr>
<td>Appendix E: Abbreviations</td>
<td>141</td>
</tr>
</tbody>
</table>
Management’s discussion and analysis

Critical accounting estimates

Summary of issues noted
The SEC staff’s comments related to disclosure effectiveness have targeted repetitive discussion in MD&A about critical accounting estimates. The SEC staff has reminded registrants that MD&A should supplement, but not repeat, disclosure in the significant accounting policies note of the financial statements. The SEC staff often requests registrants to focus their MD&A discussion of critical accounting estimates on the quality and variability of management’s most significant judgments and assumptions.

Analysis of current issues
Critical accounting estimates are those that are most important to the financial statement presentation and that require the most difficult, subjective and complex judgments. SEC Financial Release No. 72, Commission Guidance Regarding Management’s Discussion and Analysis of Financial Condition and Results of Operations (FR-72), reminds registrants that MD&A rules require disclosure of a critical accounting estimate in either of the following cases:

- The nature of the estimates or assumptions is material because of the levels of subjectivity and judgment needed to account for matters that are highly uncertain and susceptible to change
- The effect of the estimates and assumptions is material to the financial statements

The SEC staff has noted that registrants’ disclosures about critical accounting estimates often are too general and should provide a more robust analysis than what is in the notes to the financial statements. The SEC staff has commented that there are numerous examples of portions of the significant accounting policies note being repeated verbatim in MD&A. While accounting policies in the notes to the financial statements generally describe the method used to apply an accounting principle, the discussion in MD&A should provide more insight into the uncertainties involved in applying the principle at a given time and the variability that is reasonably likely to result from its application.

Example SEC staff comment: Duplicative disclosure about critical accounting estimates

Your Critical Accounting Policies within MD&A appears to be a duplication of the accounting policies already disclosed in the notes to your financial statements. Please modify your disclosure to include disclosure that addresses the specific methods, assumptions and estimates underlying your critical accounting measurements. If you prefer to include this disclosure elsewhere in your filing, such as expanded disclosure in the notes your financial statements please consider including a simple cross reference within your MD&A to avoid repetition.
Registrants can consider a cross-reference to footnote disclosure about significant accounting policies but should expand the MD&A disclosure to (1) address why the accounting estimate or assumption bears the risk of change and (2) analyze the following if material:

- How the registrant arrived at the estimate/assumption
- How accurate the estimate/assumption has been in the past
- How much the estimate/assumption has changed in the past
- Whether the estimate/assumption is reasonably likely to change in the future

Because critical accounting estimates and assumptions are based on highly uncertain matters, the SEC believes that registrants also should consider analyzing their specific sensitivity to change based on reasonably likely outcomes that could have a material effect on the financial statements. The SEC believes that registrants should provide quantitative information, as well as qualitative disclosure, when quantitative information is reasonably available and material.

**Example SEC staff comment: Expand disclosure of critical accounting estimates**

We note certain assumptions and estimates are identified throughout your discussion of critical accounting policies. The critical accounting policies discussion should describe how these estimates and related assumptions were derived, how accurate those estimates/assumptions have been in the past, and whether the estimates/assumptions are reasonably likely to change in the future. You should provide quantitative as well as qualitative information when information is reasonably available. Tell us what consideration you gave to providing these disclosures for each of the accounting policies described.

The SEC staff may request enhancements to the MD&A discussion of particular critical accounting estimates, which we discuss separately in this publication (e.g., income taxes, goodwill impairment, allowance for loan loss).

**EY resources**

2014 SEC annual reports, Form 10-K (SCORE No. CC0399), December 2014
Liquidity and capital resources

Summary of issues noted
The SEC staff may request enhanced disclosures in the liquidity and capital resources section of MD&A, particularly when there are trends or uncertainties affecting liquidity. The SEC staff focuses on:

- Sources and uses of cash and the availability of cash to fund liquidity needs
- Implications of liquid assets held by foreign subsidiaries when there is an assertion for tax purposes that earnings of those foreign subsidiaries have been indefinitely reinvested
- Transparency in the contractual obligations table and its footnotes about interest payments and other items

Further, the SEC staff may request more comprehensive disclosures about material debt covenants when there is an elevated risk of default or when management has concluded it is reasonably likely that covenants will not be met in the future.

Analysis of current issues

General disclosures
Items 303(a)(1) and (2) of Regulation S-K require that a registrant discuss known material trends, demands, commitments, events or uncertainties that are reasonably likely to affect (either favorably or unfavorably) liquidity or capital resources. The SEC staff requests that registrants expand MD&A to include a meaningful analysis and discuss the material components to explain the variability of cash flows. For example, the SEC staff often challenges the discussion about cash flows that recites items that are readily apparent from the statement of cash flows (e.g., changes in working capital) but does not provide analysis about the underlying drivers for material changes.

Further, the SEC staff may ask registrants to expand MD&A to include a discussion of increases or decreases in liquidity and capital resources from events that have occurred or are reasonably likely to occur. For example, if a registrant expects growth in the business from a recently completed acquisition, the SEC staff may expect a discussion of the likely result in liquidity increasing (or decreasing) in any material way.

Example SEC staff comment: Changes in operating cash flows
Your discussion of net cash provided by operating activities does not appear to contribute substantively to an understanding of your historical cash flows. When preparing the discussion and analysis of operating cash flows, you should address material changes in the underlying drivers that affect these cash flows. These disclosures should include a discussion of the underlying reasons for changes in working capital accounts that affect operating cash flows.

The SEC staff also has requested that registrants disclose the following:
- Whether identified trends will continue and for how long, as well as steps the registrant is taking to address the trends, including plans to remedy any identified material deficiency in short- or long-term liquidity.
Management's discussion and analysis

- An analysis of all internal and external sources of liquidity, beyond cash on hand, as of the balance sheet date
- Amounts outstanding and available at the balance sheet date under each source of liquidity, with a comparison to cash needs over the next 12 months, including any significant planned capital expenditures
- The sufficiency of the amount available under an existing short-term credit arrangement, the anticipated circumstances requiring its use, any uncertainty surrounding the ability to access funds when needed and the implications of not being able to access the arrangement

When there is a heightened risk of debt default (e.g., adverse trends in cash flows or operating results, recent waiver requests, significant amount of debt maturing within 12 months), the SEC staff requests supplemental information and often disclosure about debt covenants and the potential risks and effects of noncompliance on the registrant’s financial condition and liquidity. Specifically, the SEC staff may request the following types of disclosure:

- Specific terms of material debt covenants and performance relative to the covenants
- Actual quantitative ratios or amounts compared with required minimum/maximum values contained in debt covenants, along with explanations of how such ratios or amounts are determined and their relationship to amounts reported under US GAAP
- The nature of waivers or modifications of existing debt covenants obtained to cure or prevent potential violation(s), including how long any waivers apply and a description of the related covenant
- Disclosure of the likelihood of failing financial covenants in the future

Foreign earnings

The SEC staff continues to request that registrants consider the effect on consolidated liquidity when they assert their intention to indefinitely reinvest foreign earnings under ASC 740. The SEC staff requests disclosure of the amount of cash and short-term investments held by foreign subsidiaries that are not available to fund domestic operations unless the funds are repatriated and the potential income tax payments that would be required upon repatriation.

In response to these requests, registrants have provided MD&A disclosure such as, “As of December 31, 2014, $2 billion of the $2.5 billion of cash and short-term investments (on the consolidated balance sheet) was held by foreign subsidiaries.” Following this type of disclosure, the registrant then may be asked to discuss the income tax implications of repatriation and the effects of repatriation on liquidity.

This can be an important disclosure for investors to understand the liquidity of the registrant. While a registrant may appear to have significant liquid assets, a large portion of those assets may not be generally available for use domestically without material tax implications.
Example SEC staff comment: Foreign earnings

If significant to an understanding of your liquidity, in future filings please clarify the amount of cash and investments held outside of the US. Additionally, to the extent material, please describe any significant amounts that may not be available for general corporate use related to cash and investments held by foreign subsidiaries where you consider earnings to be indefinitely invested. Also, address the potential tax implications of repatriation.

Contractual obligations

Item 303 of Regulation S-K requires registrants (other than smaller reporting companies, issuers of asset-backed securities and registered investment companies) to provide tabular presentations of known contractual obligations as of the end of the most recent fiscal year.

The goal of the contractual obligations table is to present a meaningful snapshot of cash requirements arising from those obligations. The MD&A rules permit flexibility so that the presentation can reflect company-specific information in a way that is suitable to a registrant’s business. Registrants should develop a presentation that is clear and understandable and that appropriately reflects the categories of obligations that are meaningful in light of their capital structure and business.

Uncertainties about what to include in the table and how to allocate amounts to the required periods should be resolved consistent with the purpose of the disclosure. Registrants should consider providing narrative disclosure, in addition to the table and related footnotes, to promote an understanding of the tabular data.

The SEC staff has questioned the completeness of items included in registrants’ contractual obligations tables and has asked those companies to provide the reasons for excluding certain items from the table. Most notably, the SEC staff has asked companies to include amounts for future interest payments in the contractual obligations table or a footnote to the table, if material. When interest rates are variable, registrants should describe the assumptions that were used to estimate future payments.

Example SEC staff comment: Contractual obligations

Since your payments of interest are material to your cash flows, we believe you should include scheduled and/or expected interest payments in the table. Where interest rates are variable and unknown, you may determine the appropriate methodology to estimate the interest payments with disclosure of the methodology used in your estimate. If you continue to exclude interest payments from the table, please disclose the significant contractual terms of the debt and any other information that is material to an understanding of these future cash flows.

EY resources

2014 SEC annual reports, Form 10-K (SCORE No. CC0399), December 2014
Results of operations

**Summary of issues noted**

The SEC staff often requests that registrants explain the results of their operations with greater specificity, including identifying underlying drivers for each material factor that has affected their earnings or that is reasonably likely to have a material effect on future earnings. In addition to the analysis of changes in revenue, the SEC staff recently has commented more often on significant components of expenses and provisions.

The SEC staff also has increased its focus on performance metrics, including whether registrants have disclosed key metrics monitored by management and how those metrics correlate to material changes in the results of operations.

**Analysis of current issues**

Item 303(a)(3) of Regulation S-K provides general instructions for preparing MD&A disclosures about the results of operations. The SEC staff often asks registrants to include a more detailed discussion as required by Item 303(a)(3), including requesting that registrants:

- Describe any unusual or infrequent events or transactions, or any significant economic changes, that materially affect income from continuing operations as well as the extent to which income was affected (e.g., significant events that have been disclosed in the press but not disclosed in an SEC filing)
- Describe any other significant components of revenue or expense necessary to understand the results of operations (such as components of cost of sales)
- Describe any known trends, events or uncertainties that have had or are expected to have a material effect on sales, revenue or income from continuing operations (such as the effect of uncertainties resulting from foreign operations in countries subject to political or financial risk)
- Discuss how much of any material increase in net sales or revenue is due to business combinations, increased sales volume, introduction of new products or services, or increased sales prices and quantify, if possible, each factor’s effect
- In addition to discussing the registrant as a whole, discuss segment information needed to understand the registrant’s results of operations, including the effect the performance of a particular product line may have had

The SEC staff typically requests more granular quantification and discussion about the specific factors (including material offsetting factors), and the underlying business or economic reasons, that contributed to material period-to-period changes. For example, when a registrant discloses that two or more factors have contributed to a material period-to-period change in a financial statement line item, the SEC staff often requests that each factor be quantified and analyzed to provide more meaningful disclosure.
Example SEC staff comment: Results of operations – quantification of factors

Please revise future filings to quantify the extent to which increases/decreases in volume, prices, the introduction of new products, and inflation impacts of raw materials contributed to the changes in net sales and gross profit margin and/or segment operating profit. In addition, please quantify and more fully explain the impact of other factors you identify that contributed to fluctuations in line items included in income from continuing operations. Please refer to Items 303(A)(3)(i) and 303(A)(3)(iii) of Regulation S-X and Sections 501.12.b.3. and 501.12.b.4. of the Financial Reporting Codification for guidance.

At the 2014 AICPA National Conference on Current SEC and PCAOB Developments (2014 AICPA Conference), the SEC staff reminded registrants about the requirement in Item 303 of Regulation S-K to provide forward-looking information about known trends and uncertainties. This information is required for uncertainties that have had or are reasonably likely to have a material effect on revenues or income from continuing operations.

The staff noted that when a material trend or uncertainty is known, registrants must consider whether to disclose the trend or uncertainty. First, the registrant must determine whether the trend or uncertainty is reasonably likely to occur. If it isn't, no disclosure is required. If the registrant cannot make that determination, it must assume that the uncertainty will occur and it must disclose that item in MD&A, unless it is not reasonably likely to have a material effect.

When registrants disclose exposures to foreign exchange fluctuations or economic conditions (e.g., sustained low interest rates), the SEC staff may ask about how these items will affect revenues and income in future periods. When material effects on results of operations are ascribed to an increase (or decrease) in headcount or other internal initiatives (e.g., IT infrastructure), the staff may ask registrants to discuss expectations about ongoing investments in these areas.

Example SEC staff comment: Results of operations – known trends and uncertainties

In future filings, please enhance your MD&A to discuss the likely impact of known trends, demands, commitments, events or uncertainties that are reasonably likely to have material effects on your financial condition or results of operations. For example, we note that your business is exposed to the impact of foreign exchange fluctuations. However, you do not provide a thorough discussion of how you believe this known trend will affect your revenues or income in future periods. Note that disclosure is mandatory where there is a known trend or uncertainty that is reasonably likely to have a material effect on your financial condition or results of operations.
Significant components of expense and changes in reserve balances

The SEC staff recently has asked registrants to include more discussion about significant components of operating expenses, such as costs of sales, in their results of operations. In the segment discussion, registrants often describe only changes in revenue and operating income and do not directly explain changes in significant operating expenses. The SEC staff frequently asks registrants to quantify and discuss separately the significant components of operating expenses that have affected segment operating income. The SEC staff believes this information helps investors better understand a registrant’s business.

In addition, the SEC staff is increasingly asking for additional information and disclosure about material provisions or reversals affecting reserve accounts (e.g., inventory reserves, bad debt allowance, sales return reserves) as well as their effects on the results of operations.

Example SEC staff comment: Results of operations – changes in reserve accounts

We note from your disclosures on page XX that your inventory reserve is relatively significant compared to your gross inventory balance. Please expand your MD&A disclosures to explain in greater detail the factors that contribute to the large inventory reserve. If sales of impaired inventory have impacted your gross margins please quantify this effect in your cost of sales discussion.

Key financial metrics

To allow investors to view the registrant through the eyes of management, FR-72 suggests that MD&A disclose key performance indicators, financial or nonfinancial, that management uses to manage the business. Key performance metrics vary by industry. For example, retail companies use same-store sales and store openings and closings, while social networking and online gaming companies typically use monthly or daily users.

The SEC staff may ask a registrant to disclose key performance indicators in its SEC filings when those metrics are included in information outside the registrant’s SEC filings (e.g., website, press releases, analyst presentations).

When a registrant uses a key metric to discuss operating results in MD&A, the SEC staff frequently requests that the registrant:

- Define the metric, especially when it is defined differently throughout the registrant’s industry
- Discuss how the metric is calculated
- Discuss any limitations on the metric’s calculation (e.g., whether an average monthly users metric might count individuals more than once)
- Consider providing information about the metric on a disaggregated basis, such as by segment, geography or revenue stream (e.g., breaking down same-store sales between e-commerce and in-store sales)
• Clearly explain how the metric or period-to-period change in the metric links to the financial statements (e.g., using the increase in the number of customers to explain revenue growth)

SEC Chair White has said that registrants must provide context about key metrics so their disclosure is not misleading. For example, if a company discloses that it has 10 million total users with an expected annual growth rate of 12%, but the majority of users are non-paying, investors may incorrectly expect a direct correlation between total user growth and profitability.

**Example SEC staff comment: Results of operations – key financial metrics**

You disclose that key drivers of revenue include growth in same-store sales, user conversion and lead pricing. Please consider quantifying these drivers for each period presented in order to supplement your results of operations discussion. Additionally, please ensure you disclose any possible limitations associated with calculating these metrics (e.g., the presence of fictitious or duplicate users), as applicable. Finally, ensure that material changes and/or trends in these metrics are addressed in your discussion of results of operations for revenue to the extent that you have not already done so.

**EY resources**

Compendium of significant accounting and reporting issues, 2014 AICPA National Conference on Current SEC and PCAOB Developments (SCORE No. CC0405), 15 December 2014

2014 SEC annual reports, Form 10-K (SCORE No. CC0399), December 2014
The SEC staff focuses its reviews on registrants’ Compensation Discussion and Analysis in an effort to promote more direct, specific and clear executive compensation disclosure. The staff may perform these reviews separately from or in conjunction with its review of the financial statement-related section of a company’s filing.

The SEC staff recently has commented on:

- Compensation decisions and the effects of peer company benchmarks, performance criteria and targets, and shareholder advisory votes
- Basis for identifying fewer than five named executive officers
- Requirements to update executive compensation disclosures in registration statements

**Analysis of current issues**

Item 402 of Regulation S-K specifies the required disclosures related to director and executive officer compensation that must be included in most proxy or information statements, as well as in Form 10-K filings and various registration statements.

The SEC staff asks registrants to consider providing sufficient detail about how they used competitor information in making compensation decisions for their named executive officers. The SEC staff asks registrants to disclose the peer companies used for benchmarking executive compensation and specify how the peer group was established. When a benchmarking exercise is material to a compensation program, the staff has asked the registrant to confirm that all identified peers were used in the benchmarking analyses and how the pay for named executive officers compared with the benchmarks (i.e., where actual payments fell within the peer range). If actual compensation differs from targeted percentiles based on these benchmarks, the SEC staff expects the registrant to provide an explanation.

The SEC staff also asks registrants to provide details on individual and corporate performance criteria and targets, both quantitative and qualitative, for each named executive. Such details include how the targets were met and how meeting those targets aligns with the overall strategy of the company. A registrant is not required to disclose the targets if doing so would result in competitive harm. Instead, it must disclose the likelihood or the difficulty of achieving the undisclosed targets.
Example SEC staff comment: Executive compensation disclosures

We note that the corporate performance measures used to determine bonus awards under your annual short-term cash incentive plan were consolidated revenue and adjusted EPS. Please disclose the targets established for both performance measures and the company’s actual performance against the targets. Also, please confirm that you will provide similar disclosure in future filings. Refer to Item 402(b)(2)(v) of Regulation S-K. To the extent you believe that disclosure of the targets is not required because it would result in competitive harm such that you may omit this information under Instruction 4 to Item 402(b) of Regulation S-K, please provide a detailed explanation of such conclusion.

Item 402(b) of Regulation S-K requires a registrant to disclose how the results of the most recent shareholder advisory vote on executive compensation were considered in determining compensation policies and decisions. The SEC staff asks registrants to disclose in future filings the results of the shareholder advisory vote and the effect on executive compensation.

Example SEC staff comment: Shareholder advisory vote

In future filings, please disclose whether and, if so, how the compensation committee has considered the results of your most recent shareholder advisory vote on executive compensation in determining compensation policies and decisions.

The SEC staff also may request that a registrant clarify the specific factors that its compensation committee considered when it exercised its discretion in granting equity awards.

Identifying named executive officers

Executive compensation information generally is required for a registrant’s principal executive officer, principal financial officer and three other highest paid executive officers. However, the registrant may not include such information for five named executive officers if an executive officer’s total compensation is less than $100,000 or the registrant cannot identify the required number of executive officers. The definition of executive officer under Exchange Act Rule 3b-7 includes any vice president in charge of a principal business unit, division or function or any other officer who performs a policy-making function. The SEC staff often requests an explanation when a registrant does not identify or provide compensation information for five named executive officers (or three executive officers for a smaller reporting company or EGC).

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1 Smaller reporting companies and EGCs only have to provide information for the principal executive officer and two other highest paid executive officers. In certain cases, registrants may have to provide information for additional executive officers who were not serving in those roles at fiscal year end.

2 Executive officers of subsidiaries may be considered executive officers of the registrant if they perform policy-making functions for the registrant.
Updating executive compensation disclosures in registration statements

In certain cases, an SEC registration statement must include executive compensation disclosures for the registrant’s most recently completed fiscal year before the Form 10-K or proxy statement is filed. For example, an initial registration statement (Form S-1 or Form 10) filed or declared effective after the end of the registrant’s fiscal year must include executive compensation disclosures for that fiscal year. In addition, a registrant, other than a well-known seasoned issuer, that files a registration statement on Form S-3 must provide executive compensation disclosures for the same period for which annual financial statements are incorporated by reference in the Form S-3, even if the proxy statement is not yet due.

The SEC staff may request that a registrant amend its registration statement or update its Form 10-K or proxy statement to include executive compensation disclosures for the most recent fiscal year before declaring a registration statement effective.

**Example SEC staff comment: Executive compensation disclosures in registration statements**

We note that your registration statement incorporates by reference your Form 10-K for the fiscal year ended December 31, 2014, which incorporates by reference Part III information from a proxy statement that has not yet been filed. Please amend your Form 10-K to include the Part III information, including executive compensation for the fiscal year ended December 31, 2014, or file your proxy statement including such information. Alternatively, please amend your registration statement to include such information. We refer you to Question 123.01 of the Securities Act Forms Compliance and Disclosure Interpretations for more information.

**EY resources**

2015 proxy statements, An overview of the requirements and observations about current practice (SCORE No. CC0401), December 2014
Summary of issues noted

The SEC staff may question the completeness and adequacy of exhibits, consents, audit reports, management signatures or certifications filed by a registrant as required by various rules and regulations. Although deficiencies in these items may seem inconsequential, they may require amendments to a registrant's filing.

Analysis of current issues

Compliance with Item 601(b)(10) of Regulation S-K

When a registrant discusses significant transactions or agreements in its disclosures, the SEC staff may inquire why the related contracts are not filed as exhibits under Item 601(b)(10) of Regulation S-K. In addition, the SEC staff may ask registrants to file missing schedules, exhibits or appendices of material contracts (e.g., a credit agreement should be filed with all of its schedules, exhibits and appendices). Registrants often can provide the missing information in a subsequent filing rather than by amending the original filing.

Example SEC staff comment: Compliance with Item 601(b)(10)

We note your disclosure regarding your collaboration agreements with ABC Sciences, Inc. and XYC Company, Inc. These agreements appear material to your business. Accordingly, please file each of these agreements as exhibits to your annual report as required under Item 601(b)(10) of Regulation S-K.

Consents and auditors' reports

Item 601 of Regulation S-K requires registrants to file the consents of experts (e.g., auditors) and counsel as exhibits to various forms filed with the SEC. Independent registered public accounting firms must consent to the use of their names and related reports in Securities Act registration statements. The SEC staff issues comments when required consents of independent registered public accounting firms:

▶ Are missing from the filing
▶ Omit the conformed signature of the accounting firm or date of issuance
▶ Refer to the incorrect auditor's report or periods covered by that report

Registrants should ensure that the “Report of Independent Registered Public Accounting Firm” also includes the conformed signature and location of the accounting firm and appropriately identifies all periods and financial statements that have been audited. The SEC staff has increasingly requested registrants and auditors to identify the version of the Integrated Framework of the Committee of Sponsoring Organizations (COSO) used to perform the assessment over internal control over financial reporting (ICFR).

Section 302 certifications

The management certification required under Section 302 of the Sarbanes-Oxley Act must be filed as Exhibit 31 to the Form 10-K. The specified form of the Section 302 certification must be filed exactly as specified in Item 601(b)(31)(i) or (ii) of Regulation S-K. Separate certifications must be filed by the principal executive officer and principal financial officer.
The SEC staff frequently asks the registrant to correct these certifications by refiling the entire report in an amendment (i.e., not simply filing a revised certification). When preparing officer certifications, registrants should:

- Follow the exact form specified by Item 601(b)(31) of Regulation S-K
- Not include the certifying individual's title in the first line of the certification
- Include a conformed signature of the signing officer at the bottom of the certification
- Include the required ICFR language in the fourth paragraph of the certification when management’s report on ICFR is included in the Form 10-K (this language may be omitted during the transition period allowed for newly public companies to comply with Item 308(a) of Regulation S-K)

**Example SEC staff comment: Section 302 certifications**

We note your Exhibit 31 Certifications do not include the full paragraph 4 disclosure as required by Item 601(b)(31)(i) of Regulation S-K. Please amend your Form 10-K to revise your certifications to include the complete introductory language of paragraph 4 as well as paragraph 4b of Item 601(b)(31) of Regulation S-K.

**Form 10-K signatures**

General instruction D of Form 10-K requires the annual report to be signed by the registrant and on the registrant’s behalf by its (1) principal executive officer(s), (2) principal financial officer(s), (3) controller or principal accounting officer and (4) by a majority of the board of directors or others acting in a similar function. If an officer signs the filing in multiple capacities (e.g., the chief financial officer is also the principal accounting officer), his or her signature line should indicate all such roles.

The SEC staff requires registrants to include a signature of the person serving as the controller or principal accounting officer or to indicate who signed the report in that capacity. It’s also important that the Form 10-K include officers’ signatures on behalf of the registrant, as well as in their individual officer capacities. Officers sometimes only sign on behalf of the registrant and not individually, or vice versa.

**Example SEC staff comment: Form 10-K signatures**

Please note that your annual report on Form 10-K must be signed by your controller or principal accounting officer. Any person who occupies more than one of the specified positions should indicate each capacity in which he or she signs the report. Please refer to General Instruction D(2) of Form 10-K and advise.

**EY resources**

2014 SEC annual reports, Form 10-K (SCORE No. CC0399), December 2014
Summary of issues noted

ICFR continues to be an area of significant focus of the SEC staff, and the number of SEC staff comments related to ICFR has increased from the previous year. This also has been a focus area for the SEC’s Division of Enforcement.

The SEC staff questions the following related to ICFR and disclosure controls and procedures:

- The nature and timely identification of material weaknesses
- The implications to ICFR when a registrant discloses immaterial error corrections regardless of materiality
- The omission of disclosures about changes in ICFR after significant events that make material changes likely, such as a business combination
- The effectiveness of disclosure controls and procedures if management’s ICFR report is improperly excluded
- The year of the applicable COSO framework in management’s ICFR report

Analysis of current issues

At the 2014 AICPA Conference, the SEC staff questioned whether all material weaknesses are being identified, noting that it is surprisingly rare to see a material weakness disclosed without a corresponding material misstatement.

As a result, the SEC staff has expressed concerns that material weaknesses are not being identified timely, and control deficiencies are not being evaluated appropriately prior to the point that a material misstatement occurs. The conclusion about the severity of a control deficiency depends on an evaluation of both the likelihood and magnitude of an error occurring without being prevented or detected by a registrant’s ICFR, not just the occurrence or magnitude of an actual error requiring correction.

When a registrant discloses a material weakness in annual or interim filings, the SEC staff said it has seen disclosures that focus on the accounting error itself rather than describing whether a control had an ineffective design or failed to operate effectively. The SEC staff may ask for additional information on the deficiency, including:

- Nature and cause of the material weakness (and financial statement error, if applicable)
- Who identified the material weakness, and when it was identified
- Whether the material weakness is more pervasive or affects other accounts or processes
- Planned actions, costs and time frame to remedy the material weakness
- How the registrant compensates for the material weakness to ensure that financial statements are free from material misstatement
- Status of any unremediated material weakness previously disclosed
- Effect on disclosure controls and procedures when ICFR is ineffective given that ICFR constitutes a substantial element of disclosure controls and procedures
The SEC staff also questions why a registrant’s disclosures under Item 308(c) of Regulation S-K (i.e., disclosure of any material changes in the registrant’s ICFR) did not identify a change in internal control during the most recent quarter if a registrant (1) concludes its ICFR and/or disclosure controls and procedures are ineffective due to a new material weakness or (2) reports the remediation of a previously reported material weakness.

**Example SEC staff comment: Material weakness**

Please tell us the details of the material weakness related to accounting for the trade name impairment including a description of the actual control deficiency and how it was discovered. Include in your discussion any errors that were identified and corrected and what specific steps were taken to remediate the material weakness. In addition, please explain to us how you concluded that the weakness is limited to the trade name and not any other intangible assets.

In addition, if there are indicators of control deficiencies in filings, the SEC staff may ask registrants to explain whether those deficiencies were identified by management and, if so, their severity, including whether the deficiencies are material weaknesses.

For example, the SEC staff may challenge the effectiveness of ICFR when a registrant corrects an immaterial out-of-period error during the current period without revising prior period amounts. The SEC staff may question whether the correction of immaterial errors affects current and previous conclusions related to the effectiveness of ICFR and disclosure controls and procedures.

If a registrant determines that ICFR or its disclosure controls and procedures (or both) were effective despite the immaterial error correction, the SEC staff may challenge the basis of these conclusions. In particular, SEC staff is looking to better understand the nature of the deficiency that resulted in the error and likelihood that such deficiency could result in a material misstatement (notwithstanding the fact that it did not).

**Example SEC staff comment: Immaterial error correction and ICFR**

We note that during the quarter you have corrected multiple financial statement errors which you concluded are immaterial to your previously reported amounts contained in your annual report. Please provide an explanation of how you considered the identification and correction of these errors in your evaluation of internal control over financial reporting and disclosure controls and procedures.

The SEC staff challenges whether disclosures about a change in internal control under Item 308(c) of Regulation S-K should be made after a registrant acquires an entity in a business combination or has another significant event that suggests a consequential change in ICFR. The SEC rules require a registrant to disclose all material changes to internal controls, if any, and not merely that a change occurred as a result of a business acquisition. If the registrant excludes a recently acquired entity from its internal control assessment, the disclosures related to all material

When correcting an accounting error, management should carefully reassess the implications to its prior disclosures related to ICFR and disclosure controls and procedures.
changes resulting from the business combination since the date of the acquisition may be included in the first annual report in which the acquired business is included in the scope of the ICFR assessment.

Items 307 and 308 of Regulation S-K require that management’s conclusions about effectiveness explicitly state whether disclosure controls and procedures and ICFR are either “effective” or “ineffective.” Generally, the SEC staff challenges registrants that inappropriately express management’s conclusions, such as statements that disclosure controls and procedures are “adequate,” “effective, except for” or “effective except as disclosed below.”

Furthermore, if a registrant fails to complete or mistakenly omits management’s assessment of internal control from its filings, the SEC staff often asks whether disclosure controls and procedures are effective.

**Example SEC staff comment: Failure to complete management’s ICFR report**

| Please consider whether management’s failure to perform or complete its report on ICFR impacts your conclusions regarding the effectiveness of your disclosure controls and procedures as of December 31, 2014 and revise your disclosure as appropriate. |

COSO updated its internal control framework in 2013 to address changes in the business, operating and regulatory environment since it issued its original framework in 1992. However, the SEC staff has not objected to companies continuing to use the 1992 framework. As a result, the SEC staff asks registrants to identify the year of the applicable COSO framework in their ICFR reports.

**EY resources**

2014 SEC annual reports, Form 10-K (SCORE No. CC0399), December 2014

Compendium of significant accounting and reporting issues, 2014 AICPA National Conference on Current SEC and PCAOB Developments (SCORE No. CC0405), 15 December 2014

Financial reporting developments, Accounting changes and error corrections (SCORE No. BB2752), May 2015
Materiality

Summary of issues noted
The SEC staff requests that registrants identify and discuss the quantitative and qualitative factors considered when they assessed the materiality of error corrections. The SEC staff challenges a registrant’s conclusions that quantitatively large errors are immaterial.

Analysis of current issues
SAB Topic 1-M, which is codified into ASC 250-10-S99-1, includes a list of possible qualitative and quantitative factors that a registrant might consider when assessing how a reasonable investor might consider the materiality of a financial statement item, including a financial statement error. The factors listed in SAB Topic 1-M are not intended to be exhaustive, and therefore each registrant should consider all qualitative and quantitative factors that may be relevant in its circumstances. Evaluating whether an item is material requires judgment. Quantitative and qualitative factors should be individually considered in the materiality assessment. Registrants must consider qualitative factors even when the error is small. Qualitative factors also should be considered when an error is quantitatively large. However, it has been unusual for a registrant to conclude that a quantitatively significant error is not material based on qualitative factors.

The SEC staff frequently requests that registrants identify the factors they considered when assessing materiality with respect to current-period and prior-period financial statements, when registrants correct errors relating to a prior period. Management should avoid using a “check-the-box” approach to their materiality determinations. Instead, it should develop a qualitative and quantitative analysis that is specific to the registrant’s facts and circumstances and considers each period affected by the error, including quarterly and annual periods. Such an analysis also should consider the effects of errors on key performance indicators that may be important to investors, even if the indicators are non-GAAP measures.

The SEC staff may question management’s judgment when the error results in a large quantitative effect on certain key measures.

Example SEC staff comment: Materiality

We note your statement that you believe that the impact of the error is not material in accordance with ASC 250. In this regard, we also note that the error is approximately 20% of your net loss for the year. Please tell us in detail how you were able to conclude that the results of operations for the year were not materially misstated.

The SEC staff also challenges materiality assessments for a “Little r restatement,” which occurs when an error is immaterial to the prior-year financial statements, but correcting the error in the current period would materially misstate the current period financial statements. As a result, the prior-year financial statements are restated, even though the revision is immaterial to the prior year(s). In these situations, registrants generally are not required to file an Item 4.02 Form 8-K, Non-reliance on previously issued financial statements, or amend prior filings.
Instead, registrants may correct the prior-period financial statements, with appropriate disclosure, in the next periodic report that includes the prior-period financial statements. The SEC staff may request the registrant's materiality assessment to evaluate whether the method of correcting the error and related reporting are appropriate.

**EY resources**

Non-GAAP measures

Summary of issues noted
The SEC staff may request that registrants modify or provide additional disclosures when presenting non-GAAP financial measures. Comments on non-GAAP financial measures frequently focus on whether:

• The disclosures about non-GAAP financial measures comply with the requirements in Item 10(e) of Regulation S-K and related disclosure interpretations
• Certain measures are used as liquidity or performance measures, and whether the measure is reconciled to the appropriate GAAP measure

Analysis of current issues

Compliance with Item 10(e) of Regulation S-K
The SEC staff may ask registrants whether their disclosures about non-GAAP measures comply with the requirements in Item 10(e) of Regulation S-K. The staff may identify a measure in a filing that appears to be non-GAAP (e.g., it excludes amounts that are included in the most directly comparable GAAP measure) and asks how the registrant has complied with the disclosures required by Item 10(e).

Example SEC staff comment: Compliance with Item 10(e) of Regulation S-K

Please tell us whether or not management believes that Adjusted Debt is a non-GAAP measure. If so, please tell us how current disclosures meet the requirements of Item 10(e) of Regulation S-K.

The SEC staff also may ask registrants to clarify how a particular measure is useful to investors. Many times, these disclosures tend to be boilerplate or too general to help readers understand how they should use a particular measure. If a registrant cannot explain how a particular measure is useful to investors or if the staff believes the presentation could be misleading, the staff may ask the registrant to remove the non-GAAP measure.

When disclosing non-GAAP financial measures, registrants also should consider the following items that the staff commonly notes in its comment letters:

• The labeling of a non-GAAP financial measure should clearly describe the nature of any adjustments to a standard measure and should not imply that it is an unadjusted measure. For example, a measure that includes adjustments to the standard definition of EBITDA should not be labeled “EBITDA.”

• Adjustments to non-GAAP measures that are labeled as nonrecurring should only comprise items that are infrequent or unusual in nature, as required by item 10(e)(1)(ii)(B) of Regulation S-K. If the adjusted item has occurred within the past two years or is likely to recur within two years, it should not be considered nonrecurring.
Item 10(e)(1)(i)(A) of Regulation S-K requires a presentation, with equal or greater prominence, of the most directly comparable financial measure or measures calculated and presented in accordance with GAAP. The SEC staff is particularly alert for situations in which registrants give undue prominence to non-GAAP financial information either in an SEC filing or a press release.

The prohibition on presenting non-GAAP financial measures with greater prominence than GAAP measures encompasses both the order of presentation and the degree of emphasis. For example, the SEC staff may challenge a discussion of non-GAAP financial measures that precedes the discussion of the corresponding GAAP measures, or a discussion of non-GAAP measures that significantly exceeds the length of the discussion of the corresponding GAAP measures.

In addition, non-GAAP financial measures must be presented with quantitative reconciliations to the most directly comparable GAAP measures. This requirement also applies to forward-looking non-GAAP measures if the forward-looking GAAP measure is reasonably available. However, the SEC staff has objected to registrants presenting a full non-GAAP income statement as a form of reconciliation given the undue prominence it gives the non-GAAP information.

**Example SEC staff comment: Full non-GAAP income statement**

We note that you present full non-GAAP income statements. We believe that the presentation of a full non-GAAP income statement attaches undue prominence to the non-GAAP information, results in the creation of many additional non-GAAP measures (e.g., non-GAAP net sales, interest expense) and may give the impression that the non-GAAP income statement represents a comprehensive basis of accounting. Please confirm to us that you will revise your presentation to provide relevant information to investors without providing full non-GAAP income statements in future filings. For additional guidance, please refer to Compliance and Disclosures Interpretation 102.10, which is available on our website at [http://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm](http://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm).

**Liquidity versus performance measures**

Non-GAAP financial measures may be presented as performance measures, liquidity measures or both. When a non-GAAP measure is used as both a performance and liquidity measure, multiple reconciliations may be necessary. For example, EBITDA generally should be reconciled to net income if it is presented as a performance measure and to cash flows from operations if it is presented as a liquidity measure.

The SEC staff may question a registrant’s disclosure that indicates a non-GAAP measure is a liquidity measure (e.g., used to assess ability to service debt, generate cash flows or fund acquisitions and capital expenditures), but the non-GAAP measure is reconciled only to a performance measure such as net income. The SEC staff may request that registrants revise their disclosure to clarify how the non-GAAP measure is used (i.e., as a performance or liquidity measure) and include the appropriate reconciliation to the most directly comparable GAAP measure.
When a registrant discloses a non-GAAP liquidity measure, it is precluded under Item 10(e)(ii)(A) from excluding charges or liabilities that require cash settlement. If a non-GAAP measure is presented as a liquidity measure, the SEC staff may challenge the appropriateness of certain adjustments (e.g., excluding certain charges or liabilities that require, or will require, cash settlement) that might otherwise be acceptable when calculating non-GAAP performance measures.

**Example SEC staff comment: Non-GAAP liquidity measures**

We note your disclosure that you believe that Adjusted EBITDA is helpful as an indicator of the company’s financial performance and capacity to operationally fund capital expenditures and working capital requirements. Please tell us how you considered Item 10(e)(1)(ii)(A) of Regulation S-K. In this regard, we note that the description of the measure suggests its usefulness in part as a liquidity measure and the measure appears to exclude items that require cash settlement.

**EY resources**

2014 SEC annual reports, *Form 10-K* (SCORE No. CC0399), December 2014
Summary of issues noted
SEC regulations require registrants to provide additional financial information under certain conditions or events, including when they (1) make a significant acquisition (Rule 3-05), (2) have a significant equity method investee (Rules 3-09 and 4-08(g)) or (3) have registered guarantees (Rule 3-10). The financial statement requirements for each rule are based on whether certain thresholds are met, and each rule has specific requirements for what financial statements to include in a filing. The SEC frequently questions whether a registrant has appropriately applied these rules.

Analysis of current issues

Financial statements of a business acquired (Rule 3-05)
When an acquisition of a significant business has occurred or is probable, Rule 3-05 requires the registrant to file separate pre-acquisition historical financial statements for the acquired entity. The SEC staff frequently requests the registrant’s detailed analysis to determine whether Rule 3-05 was applied appropriately (including the tests of significance).

Financial statements of equity method investees (Rules 3-09 and 4-08(g))
When there are indications that a registrant may have significant equity method investees, the SEC staff may request the registrant’s analysis evaluating the need for separate financial statements or summarized financial information of the investees under Rules 3-09 and 4-08(g) of Regulation S-X, including the detailed significance tests. The SEC staff’s comments generally vary depending on the registrant’s facts and circumstances. However, the SEC expects strict application of the significance tests, unless a request for relief has been granted. Registrants that do not appropriately apply the requirements or fail to timely file investee financial statements may face consequences, such as the loss of Form S-3 eligibility and ineffective disclosure controls and procedures.

Financial statements of guarantors (Rule 3-10)
The SEC staff often asks registrants about their compliance with the criteria that permit financial reporting relief under Rule 3-10 of Regulation S-X. The staff asks registrants to (1) confirm and disclose that the subsidiary issuers and guarantors are 100% owned rather than “wholly owned” and (2) clarify that guarantees are full and unconditional.

In recent years, the SEC staff has focused on the form and content of condensed consolidating financial information disclosed in the parent company’s consolidated financial statements in lieu of separate financial statements for each subsidiary issuer and guarantor of registered debt securities. Form and content continues to be an area of focus for the SEC staff, including whether the individual columns in the consolidating financial information comply with Regulation S-X and are prepared in accordance with GAAP.

EY resources
2014 SEC annual reports, Form 10-K (SCORE No. CC0399), December 2014
Compendium of significant accounting and reporting issues, 2014 AICPA National Conference on Current SEC and PCAOB Developments (SCORE No. CC0405), 15 December 2014
Financial reporting developments, Equity method investments (SCORE No. BB2634), September 2014
Summary of issues noted
The SEC staff may ask registrants about pro forma financial information disclosed in filings, including registration statements, proxy statements and Forms 8-K. The SEC staff may request that companies explain how they have met the requirements of Article 11 of Regulation S-X. The SEC staff also may ask for more transparent disclosure about how they calculate pro forma adjustments.

Analysis of current issues
The objective of pro forma financial information is to help investors understand the effect of a significant transaction, such as an acquisition or disposition, that has either occurred or is probable after the date of the historical financial statements (or is not fully reflected in the historical financial statements) by showing the effect on the registrant's historical financial statements “as if” the particular transaction occurred at an earlier time. Article 11 of Regulation S-X describes the circumstances when pro forma information should be presented in SEC filings and the form and content for the presentation.

Pro forma adjustments included in pro forma financial information to provide this “as if” perspective of a transaction must be (1) directly attributable to each specific transaction, (2) factually supportable and (3) expected to have a continuing impact (income statement only). The SEC staff’s questions about pro forma adjustments often cite specific Article 11 criteria and ask how pro forma adjustments comply.

Directly attributable
Pro forma adjustments should be directly attributable to the transaction reflected in the pro forma financial information. Pro forma financial information should exclude adjustments that reflect how historical management practices and operating decisions may have been different as a result of the transaction.

The SEC staff may question adjustments that do not appear to be directly attributable to the transaction reflected in the pro forma financial information. For example, in pro forma information giving effect to a significant acquisition, a restructuring charge recognized in the target’s historical financial statements would be unrelated to the business combination and should not be eliminated from the pro forma financial information.

Factually supportable
Pro forma adjustments should be factually supportable. The SEC staff has indicated that an adjustment generally would be considered factually supportable if there is reliable documented evidence, such as an executed contract or completed transaction. For example, the SEC staff may challenge registrants when they include in their adjustments a new compensation arrangement expected following a business combination if an executed agreement does not yet exist. The SEC staff also has indicated that the effects of some events and transactions are too uncertain to be considered factually supportable. For example, a company should not eliminate compensation expense on a pro forma basis for employees terminated following a business combination because the related effects on revenues and operations would be too uncertain.
Example SEC staff comment: Pro forma adjustments

We note that you have included a pro forma adjustment to eliminate compensation to the company’s chief executive officer because she will perform limited duties under a consulting agreement subsequent to this offering. Since we assume that the compensation historically paid was commensurate with the duties she performed, please revise to eliminate this adjustment.

Continuing impact

Pro forma income statement adjustments must have a continuing impact on the registrant. The SEC staff may ask a registrant to explain how an adjustment has a continuing impact. The SEC staff has historically used a 12-month rule of thumb to evaluate the continuing impact criterion. However, certain items that affect the pro forma income statement for a period of less than 12 months still may be considered to have a continuing impact. The evaluation will depend on the individual facts and circumstances. For example, an adjustment for interest expense on a bridge loan that may be incurred for a period of less than 12 months might be considered to have a continuing impact.

Example SEC staff comment: Pro forma adjustments

We note your disclosure that you have included an adjustment to the pro forma statement of operations to recognize a $5 million 3% call premium for the repayment of debt. Please tell us how you determined that this expense is a recurring item and revise your disclosures accordingly. Please refer to Articles 11-02(b)(5) and 11-02(b)(6) of Regulation S-X for guidance.

Transparency of pro forma adjustments

In addition to meeting the criteria in Article 11 of Regulation S-X, pro forma adjustments should be clearly presented. The following disclosures should be included in the notes to the pro forma financial information:

- The nature of pro forma adjustments
- How pro forma adjustments are calculated
- The assumptions used to determine such amounts

For example, if two partially offsetting pro forma adjustments are presented in the aggregate to adjust deferred tax liabilities in the pro forma balance sheet, the notes to the pro forma financial information should explain the two gross adjustments within the net adjustment presented on the face of the pro forma financial information. The SEC staff often will ask for clarification or additional disclosure when it’s unclear how pro forma adjustments were calculated, or when the amount of the total or net adjustment does not agree with the underlying gross pro forma adjustments explained in the notes.

Registrants should clearly disclose how pro forma adjustments are calculated.
**Example SEC staff comment: Pro forma adjustments**

Please expand your disclosure to provide a more detailed description of all of the pro forma adjustments reflected. Your revised disclosure should include a discussion of the methodologies used by the company to determine fair value as well as a listing of any material assets or liabilities currently shown net in the footnote (i.e., above market lease intangibles and lease origination costs reflected as “lease intangible assets”).

**EY resources**

Pro forma financial information, *A guide for applying Article 11 of Regulation S-X* (SCORE No. CC0416), September 2015
Summary of issues noted

The SEC staff asks about third-party restrictions that appear to (1) limit the ability to pay dividends to shareholders or (2) limit the ability to transfer net assets from subsidiaries. If such restrictions exist, the SEC staff asks registrants to provide the disclosures required by Rule 4-08(e) of Regulation S-X. The SEC staff also asks registrants about how they considered the requirements under Rule 5-04 of Regulation S-X to present condensed financial information on an unconsolidated basis (i.e., parent company financial statements).

Analysis of current issues

Rule 4-08(e) of Regulation S-X requires registrants to include disclosures in the notes to the financial statements about restrictions that limit their ability to pay dividends. It also requires disclosures about restrictions on transfers of net assets from subsidiaries and investees to the parent. The SEC staff often issues comments related to this area to registrants in the insurance industry because of their legal structures, but the disclosure requirement applies to all registrants.

The SEC staff may use a registrant’s footnote disclosures about debt as the basis for inquiring about compliance with the requirements of Rule 4-08(e). For example, the footnote may describe certain restrictions imposed by financial covenants on the registrant or its subsidiaries (e.g., quantitative working capital requirements, restricted amounts of net assets).

The SEC staff also raises questions about a registrant’s compliance with Rule 5-04(c) and Rule 12-04 of Regulation S-X. Rule 5-04(c) requires registrants to include parent-only condensed financial information on Schedule I, Condensed financial information of registrant, using the form and including the content required by Rule 12-04 when restricted net assets of only the registrant’s consolidated subsidiaries exceed 25% of the registrant’s consolidated net assets. This schedule shows investors the amount of net assets, operations and cash flows at the parent level on a standalone basis with all subsidiaries reflected on an unconsolidated basis (i.e., under the equity method).

Example SEC staff comment: Rule 4-08(e) disclosures and parent-only financial information

You disclose that the restricted payments covenant in the indenture governing your notes as well as restrictions in your credit facility generally limit your ability to pay dividends to your parent. Please discuss any restrictions on your ability to declare dividends and the impact on your liquidity, financial condition and results of operations based on these restrictions. Please provide, if necessary, the disclosures required by Rule 4-08(e) of Regulation S-X. Please also tell us what consideration you gave to the need for parent-only financial statements under Rules 5-04 and 12-04 of Regulation S-X.

EY resources

2014 SEC annual reports, Form 10-K (SCORE No. CC0399), December 2014
Other SEC reporting issues

Summary of issues noted

The SEC staff may question how a registrant complies with the various disclosure requirements of Regulation S-K or other SEC rules and request additional disclosures, if material.

Analysis of current issues

The following is a brief overview of SEC disclosure areas where the staff continues to issue comments requesting compliance.

Business disclosures

Item 101 of Regulation S-K requires disclosure about the registrant’s business, including a description of its products or services, segments and geographic areas. Although the nature of SEC staff comments may vary significantly in this area, depending on the registrant’s facts and circumstances, the SEC staff typically comments on the required disclosures about backlog, customer concentration, material supply/collaboration agreements and patents.

Market risk disclosures

Item 305 of Regulation S-K requires quantitative and qualitative disclosures about market risks (e.g., interest rate risk, foreign currency exchange risk) related to possible economic losses caused by changes in rates or prices. Market risk disclosures must be disclosed in one of three ways: (1) a comprehensive table that schedules cash flow amounts by maturity dates, (2) a sensitivity analysis that quantifies the effect of at least one hypothetical change in market conditions or (3) specified “value at risk” disclosures that measure the potential exposure to adverse market movements over a specified time period. The SEC staff may question registrants that have not included market risk disclosures using one of the methods required by Item 305 or request additional information about the financial instruments considered in the registrant’s analysis.

Risk Factors — General

Item 503(c) of Regulation S-K requires a registrant to disclose its significant risks and how it is affected by each of them. Risk factors should be specific to the registrant’s facts and circumstances and not merely general risks that could apply to any registrant. The SEC staff commonly questions risk-factor disclosures that could apply to any public company. It also may question the completeness of a registrant’s risk-factor disclosures based on information included elsewhere in the document or other public information (i.e., earnings call).

With the increase in the frequency and severity of cyber attacks and data breaches, cybersecurity continues to be an area of focus for the SEC staff. CF Disclosure Guidance: Topic No. 2, Cybersecurity, (issued by the staff of the Division of Corporation Finance) provides a framework for registrants to consider in evaluating whether to disclose information about risks and incidents involving cybersecurity. The SEC staff guidance notes that material cybersecurity risks or cyber incidents must be disclosed when necessary to avoid potential incomplete or misleading disclosures.
Selected quarterly financial data
The SEC staff has commented when registrants disclose selected quarterly information in filings that does not comply with Item 302 of Regulation S-K. The SEC staff’s comments in this area relate to disclosures that fail to note the effect of material disposals of business segments and extraordinary, unusual or infrequently occurring items recognized in each quarter within the two most recent fiscal years.

Officers and directors
Items 401 and 407 of Regulation S-K require registrants to disclose information about its executive officers and directors and certain corporate governance information. In its comments, the SEC staff has asked registrants to expand or include disclosures to meet the requirements in areas such as:

- Business experience and qualifications of officers and directors for the previous five years as required by 401(e)(1)
- Inclusion of all executive officers as defined
- Director independence, qualification and legal proceedings involving company directors for the past 10 years as required by 401(f)

Related-party transactions
The SEC staff may request that registrants clarify or expand their disclosures about related-party transactions as required by Item 404(a) of Regulation S-K. Item 404(a) requires a registrant to describe related-party transactions (both actual and proposed) exceeding $120,000 since the beginning of its last fiscal year, and in which any related party had or will have a direct or indirect material interest. The SEC staff expects the description of a particular transaction to summarize the nature of the transaction in quantitative and qualitative terms and include any material additional information.

State sponsors of terrorism
The SEC staff may comment on disclosures about liquidity, risk factors and results of operations for registrants with foreign operations in countries that have been identified by the US Department of State as state sponsors of terrorism, including Syria, Iran and Sudan. The SEC will search a registrant’s publicly available information (e.g., websites) for connections to the restricted countries, including comments related to unaffiliated retail locations where a registrant’s branded product is sold. For further discussion, please refer to Appendix C: Foreign Private Issuers supplement.

EY resources
2014 SEC annual reports, Form 10-K (SCORE No. CC0399), December 2014
Financial statement presentation

Income statement presentation

Summary of issues noted

The SEC staff may ask registrants to provide information supporting their conclusions on the appropriate presentation of revenue and cost of sales in the income statement. Specifically, the SEC staff focuses on the income statement presentation guidance in Rule 5-03(b)(1) and (b)(2) of Regulation S-X.

Analysis of current issues

Many registrants derive revenues from the sale of different product categories or the sale of both products and services. In such cases, presentation of revenues by category may provide meaningful information to the users of the financial statements, particularly if the gross margins of the various categories of transactions are disparate. Rule 5-03(b)(1) of Regulation S-X requires the following items to be separately stated on the face of the income statement, unless the amount is less than 10% of total revenue:

- Net sales of tangible products (gross sales less discounts, returns and allowances)
- Operating revenue of public utilities or others
- Rental income
- Revenue from services
- Other revenues

Rule 5-03(b)(2) of Regulation S-X requires that costs and expenses applicable to sales and revenues be presented on the face of the income statement in categories similar to the revenue categories above.

When other disclosures in a registrant’s filings (e.g., MD&A discussion) or public materials (e.g., an earnings release) refer to revenue being derived from various sources, the SEC staff asks registrants to provide their analyses and other information (including quantitative data by revenue source) that was used to conclude on the income statement presentation of revenue and cost of sales. Registrants should continuously monitor the revenue earned from each source to ensure they are properly presenting revenue and cost of sales attributable to the various offerings.

Example SEC staff comment: Rule 5-03(b)

Reference is made to your presentation of revenues from your business operations under the caption “Sales” on the face of your income statements. We note from your disclosures that you provide a broad range of goods and services. In this regard, please advise why you believe your presentation of revenues in the aggregate on the face of the income statement is appropriate as it appears that you recognize both product and service revenues from your business operations. As part of your response, please address how your presentation complies with the guidance outlined in Rule 5-03(b)(1), and provide us with a break out of product and services revenues which comprise total sales for each of the periods presented. Alternatively, you may revise your income statement presentation to separately state revenues from products and services, including the related costs of revenues.
Summary of issues noted

The SEC staff continues to focus on the classification of cash flows as operating, investing and financing activities in the statement of cash flows. At the 2014 AICPA Conference, the SEC staff noted an increase in the number of restatements related to errors in the statement of cash flows.

ASC 230 may be unclear or silent about how companies should classify cash flows from certain transactions, and certain cash flows may have aspects of more than one classification. As a result, registrants must apply judgment in determining the proper classification. In some cases, this has resulted in diversity among registrants in how they classify cash flows from similar transactions. In these circumstances, the SEC staff may comment on the appropriateness of cash flow classification.

Analysis of current issues

To determine how to appropriately classify cash flows (i.e., operating, investing or financing) when the guidance in ASC 230 is not explicit, a registrant must analyze the nature of the activity and the predominant source of the related cash flows and do the following:

- Retain documentation of its rationale for classification
- Provide transparent disclosure of classification either on the face of the statement of cash flows or in the notes to the financial statements

When the SEC staff asks registrants to explain the classification basis for items in the statement of cash flows, the registrant should explain the judgment it applied in determining the classification. However, even registrants that make transparent disclosures may receive comments from the SEC staff about the basis for cash flow conclusions. Retaining sufficient documentation about such conclusions will help registrants respond to SEC staff questions.

The SEC staff also may request that registrants expand their significant accounting policy footnote disclosures to address how certain items are classified in the statement of cash flows and the basis for their accounting policy.

Example SEC staff comment: Statement of cash flows presentation

Regarding the consolidated statements of cash flows, please explain where the contingent consideration payments made in connection with the purchase of a business are classified and the basis for such classification. Refer to the accounting literature in supporting the basis for classification.

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3 As of the date of this publication, the Emerging Issues Task Force (EITF) has an open agenda project (Issue 15-F) aimed to reduce diversity in practice on nine specific cash flow issues, including several areas where the SEC staff frequently questions the cash flow classification. Additional guidance could reduce diversity and SEC staff comments on these topics. Refer to our EITF Update, June 2015 meeting highlights for further discussion.
EY resources

Compendium of significant accounting and reporting issues, 2014 AICPA National Conference on Current SEC and PCAOB Developments (SCORE No. CC0405), 15 December 2014

Financial reporting developments, Statement of cash flows – Accounting Standards Codification 230 (SCORE No. 42856), June 2015
Summary of issues noted

The SEC staff asks registrants to provide, in both the financial statements and MD&A, a robust description of the accounting policies and methods used to estimate the allowance for doubtful accounts. The staff also may ask registrants to explain unusual fluctuations in historical financial relationships, such as the allowance for doubtful accounts as a percentage of the accounts receivable balance.

Analysis of current issues

ASC 310 provides the basic disclosure requirements for accounts receivable. Registrants with sales that result in accounts receivable should have accounting policies and methods to estimate an allowance for doubtful accounts. They also should have policies for writing off uncollectible trade receivables. The SEC staff may request disclosure about how a registrant determines its allowance for doubtful accounts, including the significant assumptions used.

When conditions cause significant or unusual changes in accounts receivable or in the allowance for doubtful accounts, the staff may request that registrants disclose the factors that led to the changes, why the balances changed so significantly, whether any specific customers caused the changes and what steps management has taken to collect outstanding balances.

The staff has asked registrants to provide additional information related to financial ratios and relationships, including:

- The relationship between revenue amounts, accounts receivable balances and allowances for doubtful accounts, including the reasons for any changes in these relationships over time
- Changes in the balance of accounts receivable from one reporting period to the next, and the effects of those changes on cash flows from operating activities
- Policies for extending credit, and how those policies affect the accounts receivable and allowance balances
- The number of days’ sales in accounts receivable, including any differences between that amount and the registrant’s standard credit terms
- Changes in coverage ratios (e.g., the ratio of allowance for doubtful accounts to accounts receivable) from one reporting period to the next
- Significant past due balances and the collectability of amounts that continue to remain uncollected
Business combinations

Summary of issues noted
The SEC staff may request registrants to enhance or explain their business combinations disclosure by:

- Including all of the detailed disclosures required by ASC 805, including the pro forma information in ASC 805-10-50-2(h)
- Providing supplemental information and expanding disclosures about contingent consideration arrangements
- Providing supplemental information about how the registrant identified and determined the fair value of acquired intangible assets, especially when goodwill is large relative to the consideration transferred
- Providing supplemental information about how the registrant evaluated whether the acquired set of assets and activities constituted a business or an asset
- Providing supplemental information to support the appropriateness of measurement-period adjustments

Analysis of current issues

General disclosures
The disclosures in ASC 805 are intended to enable financial statement users to evaluate:

- The nature and financial effect of business combinations that occur (1) during the current reporting period or (2) after the balance sheet date but before the financial statements are issued
- The financial effects of adjustments recognized in the current reporting period that relate to a business combination that occurred in the current or previous reporting periods

The SEC staff questions whether registrants’ disclosures about business combinations are sufficient and requests registrants to expand their disclosures to provide all material information required by ASC 805. The SEC staff also questions whether registrants have complied with ASC 805-10-50-3, which requires certain disclosures for individually immaterial business combinations if they are material in the aggregate.

Example SEC staff comment: General disclosures
Please ensure that you provide all of the disclosures required by ASC 805-10-50, ASC 805-20-50, and ASC 805-30-50 for the acquisition of ABC Company. For example, for each business combination that is incomplete, please provide the information required by ASC 805-10-50-6, including the assets, liabilities, equity interests, or items of consideration for which the initial accounting is incomplete; and the nature and amount of any measurement period adjustments recognized during the reporting period in accordance with ASC 805-10-25-17.
When goodwill resulting from a business combination represents a significant portion of the consideration transferred, the SEC staff may ask the registrant to revise its disclosures to be more specific in its qualitative description of factors that make up the amount of goodwill recognized, such as the specific synergies expected from the business combination, as required by ASC 805-30-50-1.

**Example SEC staff comment: Disclosures relating to goodwill recognized**

Given the significant amount of purchase consideration allocated to goodwill please revise to describe the qualitative factors that make up goodwill such as expected synergies from the combining operations, intangible assets that do not qualify for separate recognition, or other factors. Refer to the guidance outlined in ASC 805-30-50-1. Please provide additional details beyond “expected synergies”.

ASC 805-10-50-2(h) requires pro forma disclosures assuming the acquisition occurred as of the beginning of the comparable prior annual reporting period. When pro forma disclosures are not provided, the SEC staff may ask the registrant to explain why it is impractical for the registrant to prepare the disclosures or to provide a supplemental calculation to support the registrant’s assertion that the acquisition is not material. It is important to note that the evaluation of materiality for this purpose is separate and different from the significance test performed for the purposes of presenting Article 11 pro forma financial information.

**Example SEC staff comment: Pro forma disclosures**

Please tell us your consideration of disclosing the following information to enable users of your financial statements to evaluate the nature and financial effect of the acquisition in accordance with ASC 805-10-50-2(h):

1. The amounts of revenue and earnings of the acquiree since the acquisition date included in the consolidated income statement for the reporting period
2. The revenue and earnings of the combined entity for the current reporting period as though the acquisition date for the business combination that occurred during the year had been as of the beginning of the annual reporting period
3. The revenue and earnings of the combined entity as though the acquisition occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period

**Measurement-period adjustments**

The SEC staff asks registrants to provide supplemental information about whether adjustments to initial or provisional amounts recognized for assets acquired or liabilities assumed in a business combination qualify as measurement period adjustments. The SEC also asks whether registrants have inappropriately characterized changes to the initial amounts recognized in the acquisition as measurement period adjustments rather than error corrections.
The measurement period, which cannot exceed one year, ends when a registrant obtains the additional information that it was seeking about facts and circumstances that existed as of the acquisition date or it concludes that such information is not obtainable. If an adjustment does not meet these criteria, the registrant should evaluate whether it is a correction of an error or an item that should be recognized in the current period. The SEC staff also asks registrants to disclose that the initial measurement of provisional items is incomplete.

**Example SEC staff comment: Measurement-period adjustments**

We see from your disclosures that you retrospectively adjusted provisional amounts with respect to certain acquisitions. Please explain to us when you became aware of the additional information that resulted in the adjustments. Further in this regard, please explain to us the factors you considered when you concluded that retrospective adjustments were appropriate. Refer to FASB ASC 805-10-25-18.

**Contingent consideration arrangements**

The SEC staff asks registrants to provide more robust descriptions of any contingent consideration arrangement and the basis for estimating the amount of the future payments. The SEC staff asks registrants to explain how they account for and determine the fair value of contingent payments to former owners both as of the acquisition date and in subsequent periods (including whether payments represent compensation or consideration). The SEC staff may request that registrants enhance their disclosures based on its review.

**Identification and valuation of acquired intangible assets**

The SEC staff may challenge whether additional intangible assets should have been recognized in a business combination and whether the value assigned to acquired intangible assets is appropriate. This is particularly true when registrants have allocated a significant portion of the purchase price to goodwill. For further discussion, please refer to the *Intangible assets* section of this publication.

**Determination of business or asset acquisition**

When disclosure about the acquired assets and activities is unclear, the SEC staff will ask registrants to explain how they evaluated whether the acquired set constitutes a business or an asset. The SEC staff has stated that it may question a registrant’s conclusion when the difference in accounting could be material, such as in transactions involving significant premiums, transaction costs or contingent consideration.

**EY resources**

[Financial reporting developments, Business combinations](SCORE No. BB1616), December 2014
New consolidation guidance
The Financial Accounting Standards Board (FASB) issued ASU 2015-02, Amendments to the Consolidation Analysis, in February 2015. This standard eliminates the deferral of FAS 167, which allows reporting entities with interests in certain investment funds to follow the consolidation guidance in FIN 46(R), and makes other changes to both the variable interest model and the voting model. While some have early adopted the standard, adoption will be required in 2016 for calendar year-end registrants.

Summary of potential issues noted
As discussed below, ASC 810 requires a reporting entity to make and disclose significant judgments and assumptions in determining whether it must consolidate an entity. Given these judgments and the potential significance of the new standard to certain registrants, we believe the SEC may issue comments focused on the following with respect to the financial statements in the period in which the registrant adopts ASU 2015-02:

- How a registrant determined whether fees paid to a decision maker are customary and commensurate
- How a registrant evaluated an interest held by a related party that is under common control when the decision maker does not have a direct variable interest in the related party
- How a registrant determined whether kick-out rights are substantive
- How a registrant determined whether a reporting entity has benefits when identifying the primary beneficiary

While the guidance is aimed at asset managers, it will affect all reporting entities that evaluate whether to consolidate limited partnerships or similar entities. It also may affect reporting entities that evaluate certain corporations or similar entities for consolidation.

Current consolidation guidance (prior to the adoption of ASU 2015-02)

Summary of issues noted
The SEC staff may ask registrants to explain their involvement with a variable interest entity (VIE), the structure of the VIE and their conclusion as to whether they are the primary beneficiary of the VIE. Also, the staff often requests registrants to provide disclosures related to these consolidation conclusions. Such comments could be issued particularly when the registrant is not consolidating an entity in which it owns a majority interest (e.g., applying the equity method of accounting).

Analysis of current issues
When an entity is a voting interest entity (and not a VIE), consolidation based on a majority voting interest is generally appropriate. However, when an entity is a VIE, consolidation based on a majority shareholder vote may not be appropriate.

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4 ASU 2010-10, Amendments for Certain Investment Funds.
5 FASB Interpretation No. 46(R), Consolidation of Variable Interest Entities an Interpretation of ARB No. 51
When registrants disclose that they are not consolidating entities in which they own a majority interest, the SEC staff has asked them to explain how they reached their conclusion. ASC 810 requires an entity to disclose the significant judgments and assumptions made in determining whether it must consolidate a VIE.

The SEC staff expects registrants to avoid boilerplate disclosures of the facts and circumstances they evaluated to determine the primary beneficiary and reach their consolidation conclusions. For example, the SEC staff has cautioned registrants that merely listing the contractual arrangements between an entity and the registrant does not provide sufficient insight into the judgments the registrant made in evaluating whether to consolidate the VIE.

**Example SEC staff comment: Non-consolidation of majority owned entity**

We note you hold an [majority]% interest in Entity X and you share control over major decisions. Please address the following:

1. In light of your expectation to fund approximately $[X] million of development costs, please tell us if you determined this entity is a variable interest entity. Please reference the authoritative accounting literature management relied upon in making that determination.

2. To the extent you determined this entity is a variable interest entity, please tell us how you determined you were not the primary beneficiary.

3. To the extent you determined this entity is not a variable interest entity, please tell us how you determined it was not necessary to consolidate this entity. Your response should include, but not necessary be limited to, how you resolve disagreements involving major decisions.

The SEC staff has reminded registrants that ASC 810-10-50 requires disclosure of qualitative and quantitative information about involvement with a VIE, including, but not limited to, the nature, purpose, size and activities of the VIE. Further, registrants should comply with ASC 810-10-45-25, which requires certain assets and liabilities of a consolidated VIE to be presented separately on the face of the registrants’ balance sheets. As indicated in ASC 810-10-50-2AA, registrants are also required to disclose how their involvement with a VIE affects their financial position, financial performance and cash flows. For example, registrants should disclose service fees, if material.

**EY resources**

- Financial reporting developments, Consolidation and the Variable Interest Model – Determination of a controlling financial interest (SCORE No. BB1905), September 2014
- Technical Line, New consolidation guidance will require many entities to re-evaluate their conclusions (SCORE No. BB2973), April 2015
- Technical Line, Consolidation considerations for asset managers – FIN 46(R) to ASU 2015-02 (SCORE No. BB2972), April 2015
Summary of issues noted

While loss contingencies have been a frequent area of comment over the past several years, the SEC staff has noted an improvement in the accounting and disclosure of loss contingencies. In its comments on registrants’ compliance with loss contingency disclosure requirements, the SEC staff focuses on disclosures for reasonably possible losses and the clarity and timeliness of loss contingency disclosures.

Analysis of current issues

The SEC staff’s comments address registrants’ failure to make required footnote disclosures when losses are considered reasonably possible or to disclose the range of reasonably possible losses, including when there is a reasonable possibility of a loss in excess of the amount accrued. The SEC staff seeks to verify that a registrant has considered and disclosed an estimate of the amount or range of reasonably possible losses, or, if applicable, a statement that the amount of loss cannot be estimated.

The SEC staff generally has not objected when registrants disclose either of the following, when applicable, in order to comply with the ASC 450 disclosure requirements for ranges of reasonably possible losses:

- The amount or range of reasonably possible losses on an aggregate basis
- The amount or range of reasonably possible losses in certain cases and a statement that the registrant cannot estimate an amount for other cases

The SEC staff may question how a registrant has determined that an estimate or range of loss cannot be made in a reporting period. If a registrant cannot make an estimate, the SEC staff expects it to undertake sufficient procedures to support its conclusion and may request additional information about the process.

Example SEC staff comment: Accounting for and disclosure of loss contingencies

If you conclude that you cannot estimate the reasonably possible additional loss or range of loss, please: (1) explain to us the procedures you undertake on a quarterly basis to attempt to develop a range of reasonably possible loss for disclosure and (2) tell us what specific factors are causing the inability to estimate and when you expect those factors to be alleviated.

If a registrant says an estimate cannot be made, the SEC staff looks for red flags (such as the registrant’s history with similar legal matters and the age of the litigation) that may indicate otherwise. The staff challenges disclosures that imply a need for precision in estimating the loss or range of loss because US GAAP does not require a level of “certainty” or “confidence” when estimating the range of loss.

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6 While it is acceptable to aggregate the amount or range of all reasonably possible losses, the SEC staff has objected to the aggregation of all loss categories (i.e., it is not acceptable to disclose one estimate combining probable, reasonably possible and remote loss contingencies).
The SEC staff requests that a registrant’s disclosures use terms that are consistent with the language in ASC 450 when discussing the likelihood of occurrence (i.e., probable, reasonably possible or remote) and the estimated reasonably possible loss (i.e., additional loss, range of loss, an estimate cannot be made or the estimated additional loss or range of loss is not material).

The SEC staff also expects management to evaluate its loss contingency disclosures (or lack thereof) in each reporting period. The staff expects those disclosures to evolve to include more quantitative information as the loss contingency progresses. The staff sometimes issues comments on the same matter in subsequent annual and quarterly periods.

Further, the SEC staff may challenge the adequacy of historical disclosures when loss contingencies have been settled. In particular, the staff reviews prior-period disclosures and inquires whether disclosures were appropriate in the past and whether an accrual should have been recognized in a prior period.
Summary of issues noted
Registrants continually evaluate their liquidity and capital structure and often refinance existing debt in response to changes in the economic environment (e.g., declining interest rates, improved entity-specific credit). They may amend the terms of existing debt, exchange existing debt for new debt or do both. They also may partially prepay amounts outstanding or borrow more, possibly as a result of exercising rights provided for in the existing agreement. The accounting for such transactions varies significantly, depending on whether a transaction is considered a debt modification or extinguishment, or a troubled debt restructuring (TDR). The SEC staff may ask for supplemental information to better understand how the registrant applied the relevant accounting guidance to these transactions.

Analysis of current issues
Registrants should consider the guidance in ASC 470-50 and ASC 470-60 when evaluating debt modifications and should be prepared to provide a thorough accounting analysis for the transaction in response to questions from the SEC staff.

Example SEC staff comment: Debt modification or exchange

We note that your credit agreement was amended to modify financial covenants, lower your interest rate and to extend the maturity date. In conjunction with the amendment there was also a prepayment of a portion of the outstanding principal balance. Please tell us how you accounted for the amendments and prepayment referencing ASC 470-50-40-10 through 470-50-40-12.

The SEC staff may request further explanation about:

- The calculation of the gain or loss recognized in a debt modification or exchange transaction, including the amount of costs or fees that were capitalized or expensed and the amount included in the gain or loss
- How a modification or exchange of a cash convertible instrument accounted for under ASC 470-20 was considered pursuant to ASC 470-50, and the determination of the fair value of the modified instrument, gain or loss and related journal entries
- Whether the recognition of a gain or loss is appropriate for an extinguishment when the transaction is between related parties
- How a remarketing was considered under ASC 470-50 and the determination of whether a third-party intermediary was acting as an agent or a principal in the transaction

EY resources
Financial reporting developments, Issuer’s accounting for debt and equity financings (SCORE No. BB2438), June 2014
Earnings per share

The two-class method

Summary of issues noted
The SEC staff has asked registrants for additional information about securities that participate in distributions with common stock and whether they have considered applying the two-class method to compute earnings per share (EPS).

Analysis of current issues
Companies frequently issue securities that participate in distributions with common shareholders based on a predetermined formula. Such securities are referred to as participating securities. Examples include forward contracts to sell the issuer’s common stock that adjust the strike price when dividends are paid on the underlying shares, share-based payment awards that provide for nonforfeitable dividends, general partner interests, separately transferrable incentive distribution rights (IDRs) in master limited partnerships and participating preferred stock. ASC 260 requires entities with participating securities or multiple classes of common stock to apply the two-class method to compute EPS.

In certain cases, entities have disclosed that holders of securities are entitled to participate in distributions with common stockholders. However, it may be unclear whether the two-class method was used to calculate EPS or how income was allocated to these securities.

The SEC staff has requested clarification and additional disclosure in some cases about the rights of securities to distributions (such as whether dividends are nonforfeitable), specifying whether securities are participating and how the two-class method was considered and applied.

Example SEC staff comment: Participating securities and application of the two-class method
We note that non-performance-based restricted awards under the [Restricted Stock Plan] entitle the recipients to dividends. Please tell us if these awards qualify as participating securities as defined in ASC 260-10-20. If so, please tell us what consideration you gave to presenting earnings per share under the two-class method. Please refer to ASC 260-10-45-60B.

EY resources
Financial reporting developments, Earnings per share (SCORE No. BB1971), July 2015
Financial reporting developments, Share-based payment (SCORE No. BB1172), July 2015
Summary of issues noted

Many of the SEC staff’s comments on fair value measurements and the required disclosures in ASC 820 focus on how registrants:

○ Disclose information about the valuation techniques and inputs used in their fair value measurements
○ Validate third-party information from pricing services and brokers
○ Disclose information about fair value measurements that use significant unobservable inputs (i.e., Level 3 measurements)
○ Categorize their fair value measurements within the fair value hierarchy
○ Determine the appropriate level of aggregation by class in their disclosures
○ Disclose nonrecurring fair value measurements

Analysis of current issues

Valuation techniques and inputs

The SEC staff asks registrants to provide more robust disclosures about the valuation techniques and inputs they use in determining fair value. We have observed that the staff’s questions have become more granular, frequently focusing on detailed inputs to a fair value measurement. For example, the staff may inquire about the basis for the valuation methodology applied and the basis for detailed inputs used in the valuation, such as discount rates, selected valuation multiples, cash flow forecasts and discounts/premiums applied. Further, the staff may inquire about the “weighting” assigned to multiple value indications when registrants use more than one valuation technique (e.g., internal model valuations and pricing indications from independent sources).

Example SEC staff comment: Valuation techniques and inputs

Tell us in more detail how you determined the fair value of the contingent consideration liability for each period, including, but not limited to:

(1) The valuation technique used
(2) How you evaluated the probability of achieving the required financial performance under the earnout
(3) The trends and other factors that impacted your assumptions and estimation process (e.g., tell us how sales projections changed from the initial valuation to the subsequent valuations, addressing how the projections reflected actual results and how you adjusted your assumptions as a result)

Use of third-party information

The SEC staff may inquire about the use of third-party pricing information from brokers and pricing services by registrants in all industries (not only financial institutions) that rely on this information to measure fair value. The staff may request additional disclosures, including:

○ The extent that the information provided by third parties is based on observable market data, or unobservable inputs or proprietary models
The procedures registrants use to validate the information received from third parties and to evaluate the accuracy and completeness of the inputs used

The process for adjusting prices provided by third parties and the basis for any adjustments made

Any caveats or disclaimers about the pricing information received from the third parties

**Example SEC staff comment: Third party pricing services**

We note you use third party pricing services to price your securities. Please tell us and revise MD&A disclosures in future filings to address the following areas:

1. The number of quotes or prices you generally obtained per instrument, and if you obtained multiple quotes or prices, how you determined the ultimate value you used in your financial statements

2. Whether and if so, how and why, you adjusted quotes or prices you obtained from pricing services

3. The extent to which the pricing services are gathering observable market information as opposed to using unobservable inputs and/or proprietary models in making valuation judgments and determinations

4. Describe any procedures you perform to validate the prices you obtain to ensure the fair value determination and its categorization within the fair value hierarchy is consistent with Topic 820 of the Accounting Standards Codification

**Level 3 fair value disclosures and sensitivities**

The SEC staff questions registrants about their general compliance with the disclosure requirements for Level 3 assets when these disclosures are missing, vague or incomplete. These required disclosures include the valuation processes related to Level 3 measurements, quantitative information about the significant unobservable inputs used in Level 3 measurements and a description of the sensitivity of recurring fair value measurements to changes in significant unobservable inputs. The staff has requested that registrants enhance their disclosures as follows:

- Provide weighted average information when disclosing a wide range of significant unobservable inputs for a given class of assets or liabilities and provide more information about the reasons for the wide range

- Expand their descriptions of the sensitivity of the fair value measurement to changes in the significant unobservable inputs for which quantitative information is provided and how those inputs significantly affect the fair value measurement

- When certain classes of assets or liabilities are valued using different methods, separately disclose the population valued under each method

- Enhance disclosures about the registrant’s valuation processes, including how the registrant determines its policies and procedures and analyzes changes in fair value measurements from period to period
Example SEC staff comment: Wide range of quantitative information

We note your disclosure of the range of significant unobservable inputs used in the fair value measurement of Level 3 investments. Please tell us how the broad range of many of these assumptions provides useful information to investors and explain to us why providing more precise information would not be more meaningful to investors. Additionally, given the range of assumptions, please revise your future filings to also provide a weighted average of the significant unobservable inputs reported, similar to the illustration provided in ASC 820-10-55-103, or provide a qualitative discussion around the distribution within the range.

Fair value hierarchy classification

Inquiries by the SEC staff about the categorization of assets and liabilities within the fair value hierarchy go beyond those items measured primarily using third-party pricing information. The staff also questions registrants about their basis for classifying certain assets or liabilities in a particular category in the hierarchy when the measurement is determined internally. In certain instances, the staff may challenge classifications it considers inappropriate. For example, we have observed the SEC staff request additional information about the basis for classifications of certain assets as Level 2 (rather than Level 3), such as loans and real estate owned. In addition, the SEC staff has asked about the basis for classifying assets within the hierarchy, as well as registrants’ processes for addressing transfers between hierarchy categories.

Example SEC staff comment: Fair value hierarchy classification

We note in your disclosures that you estimate the fair value of your “non-centrally cleared” interest rate swaps using inputs from counterparty and third-party pricing models to estimate the net present value of future cash flows. We further note that these assets and liabilities are classified within Level 2 of the fair value hierarchy. Please provide us with additional details to support your Level 2 classification.

Determine the appropriate level of aggregation by class

The SEC staff has questioned registrants, particularly those in the insurance industry, about their basis for aggregating in their disclosures certain fixed maturity securities into defined classes. The questions have focused on how registrants apply the guidance in ASC 820-10-50-2B, which indicates that the number of classes may need to be higher for fair value measurements categorized in Level 3 of the fair value hierarchy, because those measurements have a greater degree of uncertainty and subjectivity.

Example SEC staff comment: Level of aggregation

Refer to your disclosure of fixed maturity securities herein and in Note 3. Please provide us analyses under ASC 320-10-50-1B and ASC 820-10-50-2B supporting your presentation of fixed maturity securities by “major security types” and “classes.” In this regard, please tell us why you did not further disaggregate your state and municipal and corporate fixed maturity securities.
Nonrecurring fair value measurements

The SEC staff also has inquired about the disclosures required by ASC 820-10-50-5 for nonrecurring fair value measurements. Recent comments on these measurements have focused on obtaining additional detail about the techniques and inputs used in the valuations of contingent consideration, business combinations, impairments and other nonrecurring items.

EY resources

Financial reporting developments, Fair value measurement (SCORE No. BB1462), July 2015
Redeemable equity instruments and redeemable noncontrolling interests

**Summary of issues noted**
The SEC staff may issue comments on the accounting for redeemable equity instruments and redeemable noncontrolling interests.

**Analysis of current issues**
Redeemable equity instruments (e.g., preferred shares) may be classified as liabilities under ASC 480 if the registrant is unconditionally obligated to redeem them. Otherwise, they often are classified in the temporary equity or “mezzanine” section of the balance sheet and measured at, or accreted to, their redemption values. The accounting for these instruments is complex and based partly on the nature of the redemption feature.

Holders (or the issuer) of a noncontrolling interest may have many reasons to contractually agree to sell (or buy) the noncontrolling interest at some point in the future through a contractual redemption feature. The accounting in this area by the parent is complex because registrants need to consider the form of the redemption feature (i.e., whether it is embedded or freestanding), the nature of the redemption feature (option-like or forward-like) and the pricing of the redemption feature (fixed, variable or fair value), along with the guidance that applies to all of the variables.

The primary literature to be considered for classification of and accounting for these instruments is in ASC 480, ASC 815 and the SEC’s guidance in ASC 480-10-S99-1 and ASC 480-10-S99-3A. The SEC staff may request that registrants provide supplemental information about:

- How redemption provisions in preferred stock and noncontrolling interests are considered in determining whether liability, permanent equity or temporary equity classification is required
- Adjustments to the carrying amount of a temporary equity pursuant to ASC 480-10-S99-3A and their impact on earnings per share

**Example SEC staff comment: Redeemable noncontrolling interest**
You indicated that shares issued in the private placement will be redeemed at a specific price if you are unable to complete the acquisition of the target entity on a certain date. Tell us if you have recorded these shares outside of permanent equity and if not, please explain to us the basis of your conclusion and your consideration of the guidance in ASC 480-10-S99-3A paragraphs 4-11.

**EY resources**
Financial reporting developments, Derivatives and hedging (SCORE No. BB0977), December 2014

Financial reporting developments, Consolidated and other financial statements: Presentation and accounting for changes in ownership interests (SCORE No. BB1577), August 2015

Financial reporting developments, Issuer’s accounting for debt and equity financings (SCORE No. BB2438), June 2014
Warrants, embedded conversion features and other equity derivatives

**Summary of issues noted**

The SEC staff may ask about the classification and measurement of equity derivatives and convertible instruments that may be settled in a registrant’s own stock. The staff most commonly inquires about those instruments upon issuance. However, it may issue comments at any time during such an instrument’s life (including when its terms are modified, given that such modifications are uncommon).

**Analysis of current issues**

The SEC staff may ask for a supplemental analysis of freestanding or embedded equity derivatives, such as warrants or conversion options, and focus on how the registrant applied the guidance in ASC 815-40-15 (indexation guidance) and ASC 815-40-25 (equity classification guidance).

The SEC staff may ask a registrant how it applied specific elements of the guidance to a specific feature or provision of a financial instrument. For example, the staff might ask about what consideration was given to the guidance of ASC 815-40-15 for provisions that could adjust the conversion price of a conversion option (e.g., anti-dilution adjustment, down-round provisions).

**Example SEC staff comment: Debt with embedded conversion option**

We note that the debt instrument’s conversion rate is subject to customary anti-dilution provisions and other adjustments. Please disclose the nature of the other adjustments that would impact the conversion rate of the debt instrument. Please also tell us what consideration you gave to these anti-dilution and other adjustments in determining the appropriate accounting for the debt instrument, including your consideration of whether the adjustments would preclude the conversion feature from being considered indexed to your stock pursuant to ASC 815-40-15.

For convertible instruments that do not require bifurcation of the conversion feature, the SEC staff may ask about the consideration of the other accounting models that could require separate accounting for the conversion feature, including the guidance in ASC 470-20 on cash conversion and beneficial conversion features.

A registrant’s analysis of an equity derivative or convertible instrument requires it to consider guidance in ASC 470-20, ASC 480 and ASC 815-40. The SEC staff has commented on:

- The existence of adjustment provisions intended to protect the holder from declines in the stock price (i.e., a down-round provision)
- The application of the two-step approach in ASC 815-40-15 to determine whether exercise contingencies and settlement provisions would preclude a warrant from being considered indexed to the company’s own stock
- The evaluation of customary anti-dilution adjustment provisions in equity derivatives pursuant to ASC 815-40-15
- The consideration of the form of settlement (e.g., net cash, net share or physical settlement) when the registrant evaluated the classification of warrants under ASC 815-40-25
The treatment of the modification of existing warrants, including an analysis of the fair value immediately before and after the modification

**EY resources**

*Financial reporting developments, Derivatives and hedging* (SCORE No. BB0977), December 2014
Venezuela

Summary of issues noted

Now that Venezuela has revamped its foreign currency exchange system, companies with operations in Venezuela should reconsider the exchange rate(s) they use to remeasure their bolivar-denominated monetary assets and liabilities and related revenues and expenses.

To date the SEC staff has not objected to the exchange rate used by registrants, but it has focused its comments on how issuers have considered the multiple legal exchange rates that exist in Venezuela and how issuers determined the appropriate rate. The SEC staff has said a company’s decision to use a particular exchange rate or rates should be based on careful consideration of the various exchange mechanisms and entity-specific facts and circumstances. The SEC staff also has requested additional disclosures related to these judgments.

Analysis of current issues

In February 2015, the Venezuelan government said it merged its two supplementary foreign currency exchange systems (i.e., Sistema Complementario de Administración de Divisas, or SICAD 1, and Sistema Cambiario Alternativo de Divisas, or SICAD 2) into a single mechanism called SICAD. The government also introduced the Sistema Marginal de Divisas (Marginal Currency System, or SIMADI) to compete with the unofficial parallel currency exchange market (the black market).

SIMADI is available to individuals and both public and private companies, except for banks and other financial institutions that are authorized to facilitate exchanges through SIMADI. These financial institutions are prohibited from accessing SIMADI for their own accounts. The government has said that both the official rate and the new SICAD rate would be available to companies importing essential goods (e.g., certain food, medicine, raw materials), with the majority of such imports being settled at the official rate. However, the government has not published any new rules or regulations that clarify exactly which activities, industries or transactions will be eligible to transact at these rates.

In informal discussions, the SEC staff has said that the determination of the appropriate exchange rate to be used should be based on a company’s individual facts and circumstances. The staff has also said companies should continue to assess whether it is appropriate to continue consolidating their Venezuelan operations in accordance with ASC 810-10-15-10(aX1)(iii) and ASC 830-20-30-2.

Given Venezuela’s deteriorating economy and its currency exchange controls, the SEC staff has reiterated the following disclosures that companies should consider in the notes to their financial statements and in the business, risk factors and MD&A sections of their SEC filings, subject to materiality:

- A discussion of an entity’s operations in Venezuela, including the nature and extent of business activities in that country
- To meet this reporting objective, the entity should provide quantitative information to supplement its qualitative disclosures in a manner that management believes is most meaningful (e.g., disclosure of disaggregated financial information such as summarized balance sheet, income statement and cash flow data or net assets)
• A discussion of exchange rates used to remeasure bolivar-denominated monetary assets and liabilities, including a discussion of the company’s ability to actually transact at such rates

• Whether items were remeasured at a different rate than in the previous period (e.g., items remeasured at the SIMADI rate in the current period that were remeasured at the SICAD 2 rate in the previous period)

• Whether multiple exchange rates are used and, if so, (1) the basis for applying different rates and (2) the limitations and uncertainties of each selected rate (e.g., the amount of currency available at such rates, the company’s ability to transact through specified exchange mechanisms and to realize the rates established through those mechanisms, both historically and projected)

• The amount of bolivars pending government approval for settlement at each rate and the length of time pending

• The effect of exchange restrictions on the company’s cash flows available to meet capital and short-term funding requirements, including possible changes in profitability that may result from any additional expected currency devaluation, change in exchange rates to be used for remeasurement purposes or the existing law capping profits that can be earned in Venezuela

• Recognized impairments and debt covenant violations attributed to changes in exchange rates or other factors attributed to the entity’s operations in Venezuela

**EY resources**

Financial reporting developments, *Foreign currency matters* (SCORE No. BB2103), August 2015

Impairment analysis and disclosures

Summary of issues noted
The SEC staff has requested additional information about goodwill, including:

- Disclosures about reporting units that may be at risk of goodwill impairment and the timing of impairment losses
- Supplemental information about registrants’ impairment testing policies
- Disclosure of goodwill impairment testing policies
- Supplemental information on identifying reporting units and aggregating components, particularly when only a single reporting unit is identified

Analysis of current issues

Reporting units “at risk” of impairment
The SEC staff may request that registrants discuss in MD&A the possibility of future impairment of goodwill for any reporting unit with an estimated fair value that does not substantially exceed its carrying value (i.e., the reporting unit is at risk of failing a future Step 1 impairment test under ASC 350). This is particularly true when the registrant’s operating results (or that of the relevant segment) have declined significantly.

Example SEC staff comment: Reporting units “at risk” of impairment
To the extent that any of your reporting units have estimated fair values that are not substantially in excess of the carrying value and to the extent that goodwill for these reporting units, in the aggregate or individually, if impaired, could materially impact your operating results, please provide the following disclosures for each of these reporting units:

- Identify the reporting unit
- The percentage by which fair value exceeds the carrying value as of the most recent step-one test
- The amount of goodwill
- A description of the assumptions that drive the estimated fair value
- A discussion of the uncertainty associated with the key assumptions
- A discussion of any potential events and/or circumstances that could have a negative effect on the estimated fair value

While no bright lines exist to determine whether a reporting unit’s goodwill is “at risk,” the SEC staff expects a registrant to apply judgment when making disclosures. If goodwill impairment is identified as a critical accounting estimate, but the registrant does not have any reporting units that are at risk of failing the Step 1 goodwill impairment test, the SEC staff expects the registrant to disclose that fact in MD&A.

The SEC staff has highlighted the importance of disclosing the percentage by which the fair value exceeded the carrying value of reporting units that are at risk of impairment as of the most recent Step 1 goodwill impairment test.
The SEC staff also may question whether a registrant adequately disclosed in its previous filings a goodwill impairment charge recorded for a reporting unit that was not previously disclosed as being at risk. Further, the SEC staff may question the timing of a goodwill impairment charge, particularly when the reasons for the impairment existed in prior periods.

**Supplemental information on impairment analysis**

During the comment process, the SEC staff may ask for supplemental information about a registrant’s impairment analysis, including:

- Details of the goodwill impairment analysis for each reporting unit, including how reporting units are identified and how assets, liabilities and goodwill are assigned to reporting units
- Sensitivity analyses regarding material assumptions used in testing goodwill for impairment, including qualitative and quantitative factors, and how changes in those assumptions might affect the outcome of the goodwill impairment test
- The reconciliation of the aggregate fair values of the reporting units to the registrant’s market capitalization, and justification of the implied control premium, including relevant transactions reviewed to support the control premium
- Details of the registrant’s analysis of events that have occurred since the latest annual goodwill impairment assessment and whether those events are indicators of impairment that require an interim goodwill impairment assessment
- The type of events that could lead to a future goodwill impairment

The SEC staff may ask registrants to disclose additional information about their impairment analyses in MD&A after reviewing the supplemental information provided.

**Disclosure of accounting estimates**

The SEC staff has asked registrants to provide more robust disclosures in their critical accounting estimates section in MD&A about assessing goodwill for impairment and the details of any recognized goodwill impairment. These requests often focus on:

- The accounting policies relating to the goodwill impairment tests, including when the two-step impairment test is performed, whether the optional qualitative assessment was performed for any reporting units, how reporting units are identified and aggregated, and how goodwill is assigned to reporting units
- The facts and circumstances leading to an impairment
- How the fair value of each reporting unit was estimated, including the significant assumptions and estimates used
- Reporting units with material amounts of goodwill that are “at risk”

**Identification of reporting units and aggregation of components**

A reporting unit is an operating segment, as that term is defined in ASC 280, or one level below the operating segment, referred to as a component, depending on whether certain criteria are met.
An operating segment is the highest level that can be a reporting unit (i.e., the operating segment level is the ceiling), and the component level is the lowest level that can be a reporting unit (i.e., the component level is the floor).

For further discussion on segment reporting, please refer to the Segment reporting section of this publication.

The SEC staff may ask registrants to clarify the number and type of reporting units (e.g., operating segments or components) identified for impairment testing and include the reasons for any changes in the number of reporting units. In particular, if a registrant has completed an acquisition or reorganization, the SEC staff may request supplemental information on the reason for a change (or lack of change) in the number of reporting units and the effect on goodwill impairment testing.

**Example SEC staff comment: Identification of reporting units**

Please tell us the level at which you evaluate goodwill for impairment. We interpret your disclosures to indicate that you have only one operating segment. If our interpretation is incorrect, please clarify. If you evaluated goodwill at a component level, please explain how you determined each reporting unit and provide us a summary of the reporting units evaluated along with the related goodwill associated with each unit. If you evaluated goodwill on a single operating segment basis, please explain in detail your basis for this designation given your history of discrete business acquisitions.

**Example SEC staff comment: Change in reporting units**

Based on disclosures in your current and prior year Forms 10-K, it appears to us that there was a reduction in your reporting units from three to two. Please explain to us the reason for this change and address the affect, if any, it had on your annual goodwill impairment testing. Also, please ensure future filings adequately address any changes in reporting units.

A component of an operating segment is a reporting unit if it constitutes a business for which discrete financial information is available, and segment management regularly reviews its operating results. Segment management consists of one or more segment managers. Two or more components within the same operating segment should be aggregated and deemed a single reporting unit if the components have similar economic characteristics.

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7 For purposes of ASC 350, the term “segment manager” has the same meaning as in ASC 280.

8 ASC 350-20 states that ASC 280-10-50-11 should be considered when determining if the components of an operating segment have similar economic characteristics.
The SEC staff may ask registrants to clarify whether a single reporting unit exists or whether multiple components were aggregated into a single reporting unit. In the latter case, the SEC staff may ask the registrant for supplemental information on the specific facts and circumstances (e.g., analysis of similar economic characteristics) supporting this conclusion.

When reviewing the aggregation of components into a single reporting unit, the SEC staff considers public information available from a registrant’s earnings calls and website, and industry or analyst presentations. The SEC staff asks registrants to explain any perceived inconsistencies in how the businesses (i.e., components) are described in public information, and how components are evaluated for aggregation into a single reporting unit.

**Example SEC staff comment: Aggregation of components into a single reporting unit**

In your most recent conference call held by management there appears to be diversity in operating results for the various regions comprising the two operating segments. As such, please provide us with a more comprehensive understanding as to how you determined that the components have similar economic characteristics in light of the statements noted suggesting otherwise. Please advise and address whether additional disclosure should be provided in your footnote disclosure and/or critical accounting policies section of MD&A for the identification of your reporting units and level at which goodwill is being tested.

**EY resources**

*Financial reporting developments, Intangibles – Goodwill and other* (SCORE No. BB1499), July 2015
Income taxes

Realizability of deferred tax assets

Summary of issues noted
The SEC staff continues to focus on registrants’ accounting for the realizability of deferred tax assets and the related disclosures both in the financial statements and in MD&A. In particular, the SEC staff may question the realizability of deferred tax assets recorded by registrants that have recognized consecutive annual losses or a significant loss in the current year. The staff also may inquire when the reasons are not readily apparent why a valuation allowance was recognized initially, reversed or significantly changed.

Analysis of current issues
A valuation allowance is required if, based on the weight of available evidence (both positive and negative), it is more likely than not (i.e., likelihood of more than 50%) that some portion or all of a deferred tax asset will not be realized.

There are four sources of taxable income to be considered when determining whether a valuation allowance is required (ASC 740-10-30-18). Ultimately, the realizability of deferred tax assets depends on the existence of sufficient taxable income of the appropriate character in either the carryback or carryforward period under the tax law.

The SEC staff frequently asks registrants to provide more information about their:

- Consideration of the four sources of taxable income, including the prominence of each source and the material uncertainties, assumptions or limitations associated with each source
- Foreign tax credits and net operating loss (NOL) carryforwards, including the period over which credits and carryforwards are expected to be realized or otherwise expire unused
- Assessment of all available evidence, both positive and negative, and how the evidence was weighted in determining the realizability of deferred tax assets
- Use of similar assumptions and projections of future income to assess the realizability of deferred tax assets and assess other assets (e.g., long-lived assets, indefinite-lived intangible assets, goodwill) for impairment
- Deferred tax asset valuation allowance, particularly when either negative evidence suggests it might be necessary or positive evidence suggests it is unnecessary
- Reversal of a previously recorded valuation allowance when the positive evidence that led to this decision is not readily apparent

Overall, the questions that the SEC staff typically raises stem from what it perceives to be inadequate or overly general (e.g., boilerplate) disclosures in the financial statements and MD&A regarding how a registrant evaluated the realizability of deferred tax assets.
Further, the SEC staff may inquire about the positive and negative evidence that was considered when a valuation allowance was initially recognized, reversed or significantly changed if the reason for that change is not readily apparent. When determining the weight to place on each piece of evidence, registrants should consider how objectively verifiable the evidence is. By its very nature, future taxable income (exclusive of the reversal of existing temporary differences and carryforwards) requires estimates and judgments about future events.

Registrants should carefully assess the realizability of their deferred tax assets and make transparent and complete disclosures in their financial statements and MD&A about their deferred tax assets’ recoverability.

**Example SEC staff comment: Realizability of deferred tax assets**

Given your recurring losses before income taxes, please disclose in future filings the nature of the deferred tax assets that have not been offset by a valuation allowance and how you determined they would be realized. Please also disclose the following:

- The nature of the positive and negative evidence you considered, how that evidence was weighted, and how that evidence led you to determine it was not appropriate to record a valuation allowance on the remaining deferred tax assets;
- The amount of any pre-tax income you need to generate to realize the deferred tax assets;
- The anticipated future trends included in any projections of future taxable income; and
- State, if true, that the deferred tax liabilities you are relying on in your assessment of the realizability of your deferred tax assets will reverse in the same period and jurisdiction and are of the same character as the temporary differences giving rise to the deferred tax assets.

Please provide us your proposed disclosures.

**EY resources**

Compendium of significant accounting and reporting issues, 2013 AICPA National Conference on Current SEC and PCAOB Developments (SCORE No. CC0384), 16 December 2013

Financial reporting developments, Income taxes (SCORE No. BB1150), September 2014
Indefinite reinvestment assertions and related disclosures

Summary of issues noted
The SEC staff may challenge a registrant’s assertion that foreign earnings will be indefinitely reinvested and request evidence supporting that assertion. This line of inquiry is often accompanied by a request to reconcile a registrant’s assertion with the discussion of liquidity in MD&A.

Further, the SEC staff may ask registrants whether they have appropriately considered and included all of the disclosures required by ASC 740 when deferred taxes have not been provided on undistributed foreign earnings.

Analysis of current issues
The SEC staff may request details of specific plans when a registrant asserts that it is indefinitely reinvesting earnings of foreign subsidiaries. ASC 740-30-25-3 includes a presumption that all undistributed earnings of a subsidiary will be remitted to the parent entity. As a result, the default is to assume that the registrant will repatriate all earnings and has recognized a related provision for income taxes attributable to those earnings. For undistributed earnings of foreign subsidiaries, registrants may overcome this presumption if sufficient evidence shows that the subsidiary has invested or will invest the undistributed earnings indefinitely or that the earnings will be remitted in a tax-free liquidation.

The SEC staff has asked registrants to explain how they have overcome the presumption and to provide evidence of specific plans for reinvestment of foreign earnings (e.g., past experience, working capital forecasts, long-term liquidity plans, capital improvement programs, merger and acquisition plans, investment plans).

The SEC staff also requests similar evidence when registrants assert that they intend to indefinitely reinvest only a portion of undistributed foreign earnings or when undistributed foreign earnings are considered to be indefinitely reinvested, but there is a recent history of repatriation. In addition, when there is a change in assertion, registrants should disclose the facts and circumstances that led to it during the reporting period.

Refer to the Management’s discussion and analysis, Liquidity and capital resources section for further insight into SEC staff comments about liquidity when registrants assert that they are indefinitely reinvesting earnings of foreign subsidiaries.

Example SEC staff comment: Indefinite reinvestment assertion
We note your disclosure that you “have not provided U.S. income taxes and foreign withholding taxes on the undistributed earnings of foreign subsidiaries as of December 31, 2013 because we intend to permanently reinvest such earnings outside the U.S.” Please explain to us how you evaluated the criteria for the exception to recognition of a deferred tax liability in accordance with ASC 740-30-25-17 and 18 for undistributed earnings that are intended to be indefinitely reinvested. Describe the type of evidence and your specific plans for reinvestment for these undistributed earnings that sufficiently demonstrate that remittance of earnings will be postponed indefinitely.
When registrants assert that foreign earnings are indefinitely reinvested and deferred tax liabilities are not recognized, the SEC staff focuses on the specific disclosures required by ASC 740. ASC 740-30-50-2(b) requires registrants to disclose temporary differences (i.e., outside basis differences where the book basis of the investment exceeds its tax basis) related to investments in foreign subsidiaries and foreign corporate joint ventures that are indefinitely reinvested.

In addition, registrants are required to disclose the amount of the related unrecognized deferred tax liability if the determination of that liability is practicable. If it is not practicable, a statement to that effect is required. Notably, there is no practicability exception for disclosing the temporary difference required by ASC 740-30-50-2(b).

Registrants also should disclose the types of events or circumstances that would cause such unrecognized deferred tax liabilities to become taxable (e.g., repatriation of foreign earnings).

**EY resources**

- Financial reporting developments, Income taxes (SCORE No. BB1150), September 2014
- Compendium of significant accounting and reporting issues, 2013 AICPA National Conference on Current SEC and PCAOB Developments (SCORE No. CC0384), 16 December 2013
Income tax rate reconciliations and foreign earnings

Summary of issues noted
The SEC staff continues to express concern about the clarity of registrants’ income tax rate reconciliations and the transparency of the effect of foreign earnings on their effective tax rates. More specifically, for material rate reconciliation items associated with foreign jurisdictions, the SEC staff asks registrants to disclose the identities of specific jurisdictions that materially affect the effective tax rate, their tax rates and information about the effects of such foreign jurisdictions (e.g., magnitude, mix) on the effective tax rate.

Analysis of current issues
The SEC staff reminds registrants to clearly label items in the income tax rate reconciliation. Registrants are required to provide a reconciliation between the amount of reported total income tax expense (benefit) and the amount computed by multiplying the income (loss) before tax by the applicable statutory federal income tax rate, showing the estimated dollar value of each of the underlying causes for the difference (ASC 740-10-50-12). Reconciling items that are individually less than 5% of the computed amount may be combined in the reconciliation (Article 4-08(h) of Regulation S-X).

Example SEC staff comment: Income tax rate reconciliation
In your reconciliation of your effective income tax rate, your reconciling item labeled “Other, net” represented a 20% increase to the income tax benefit at United States federal statutory rates for fiscal 2014. Please tell us the nature of amounts included in this line item for the fiscal years presented. To the extent any individual reconciling items within this caption are greater than five percent, please revise to disclose them pursuant to Rule 4-08(h)(2) of Regulation S-X.

The SEC staff also questions whether large “provision to return” or “true-up” adjustments included in the income tax rate reconciliation reflect the correction of prior-year errors rather than changes in estimates. In addition, the staff questions registrants when information in the income tax rate reconciliation is inconsistent with the disclosures elsewhere in the filing (e.g., MD&A or valuation allowance disclosures in the notes to the financial statements).

Foreign earnings
A registrant may report a relatively low effective tax rate if it derives substantial income from low-tax-rate jurisdictions and indefinitely reinvests such earnings. In these circumstances, the registrant’s income tax reconciliation may include a large reconciling item related to these low-tax-rate jurisdictions.

The SEC staff often asks registrants that label a reconciling item as the difference between the foreign tax rate and the domestic tax rate whether they actually include more than just the rate differential in that line item (e.g., permanent differences such as tax amortization of foreign entity goodwill). When applicable, registrants should consider whether this reconciling item should be further disaggregated so that the effect of the low tax rate is presented separately from other items.
Further, if a disproportionate amount of a registrant’s profit is attributable to countries with a low tax rate, such as Ireland, the SEC staff has requested quantified disclosure of such amounts (e.g., $1 billion of our foreign profits were earned in Ireland, which has an effective tax rate of 10%).

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<th>Example SEC staff comment: Foreign earnings</th>
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<td>We note the reconciliation of your tax provision at the U.S. statutory rate to the provision for income tax as reported. Please provide to us additional details regarding the composition of the foreign tax rate differentials. In this regard, tell us which of your foreign jurisdictions had a significant impact on your foreign tax rate differential for each period presented and the pre-tax income and effective tax rates of those jurisdictions.</td>
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The SEC staff also has stated that an investor should be able to easily determine the effective tax rate attributable to a registrant’s domestic and foreign operations. To this end, the SEC staff notes that, in addition to the US GAAP disclosure requirements related to income taxes, Article 4-08(h) of Regulation S-X requires disclosure of the amount of pretax income or loss and income tax expense or benefit generated from domestic and foreign sources.

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<th>EY resources</th>
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<td>Compendium of significant accounting and reporting issues, 2014 AICPA National Conference on Current SEC and PCAOB Developments (SCORE No. CC0405), 15 December 2014</td>
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<td>Financial reporting developments, Income taxes (SCORE No. BB1150), September 2014</td>
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Intangible assets

Recognition, measurement, amortization and impairment

Summary of issues noted
The SEC staff requests registrants to provide the following information about their intangible-asset disclosures:

- Information about intangible assets recognized as part of a business combination
- Explanation of how the useful lives were determined, and for finite-lived intangible assets the factors leading to the amortization method selected
- Supplemental information on how indefinite-lived intangible assets were assessed for impairment

After reviewing this information, the SEC staff may ask registrants to enhance or revise their intangible-asset disclosures.

Analysis of current issues

Intangible assets recognized in a business combination
ASC 805 requires a registrant to determine the fair value of identifiable assets acquired and liabilities assumed (with certain limited exceptions), including intangible assets that (1) arise from contractual or other legal rights or (2) are separable.

The SEC staff’s comments focus on the values assigned to specific identifiable intangible assets, as well as the significant estimates and assumptions used in calculating fair value measurements and the subsequent accounting for such recognized intangibles. Specifically, the SEC staff requests that registrants discuss in MD&A the valuation method and principal assumptions they used to determine the fair value of each major class of intangible assets acquired.

The SEC staff also challenges whether registrants have recognized all identifiable intangible assets, particularly when other public disclosures or information about an acquisition (e.g., press releases) indicate that there could potentially be value included in goodwill that should be accounted for separately. When the goodwill resulting from a business combination represents a significant portion of the consideration transferred, the SEC staff may challenge whether all identifiable intangible assets acquired were appropriately identified and measured.

Example SEC staff comment: Identification and valuation of intangible assets when a significant amount of goodwill is recognized

In light of the significant amount of goodwill expected to be recognized, please explain to us how you evaluated this acquisition for the existence of any other intangible assets. Please refer to the guidance in ASC 805-20-55-2 through 805-20-55-51 in your response. As part of your response, please also provide us additional details of how you determined the fair value of the intangible assets recognized.

Useful life determination — indefinite-lived intangible assets
When determining the useful life of an intangible asset, a registrant should consider the period over which the asset is expected to contribute directly or indirectly to its future cash flows. Registrants should consider all of the factors listed in ASC 350...
and all other relevant information when determining the useful lives of intangible assets. The SEC staff may ask how a registrant has considered its own historical experience in renewing or extending similar arrangements (consistent with the intended use of the asset by the registrant). A registrant should consider its own historical experience even if similar arrangements did not have explicit renewal or extension provisions. A registrant should consider the useful life of an intangible asset to be indefinite only after considering all relevant facts and determining that there are no legal, regulatory, contractual, competitive, economic or other factors that limit the useful life of the intangible asset. The SEC staff also may challenge a registrant’s assertions that intangible assets have an indefinite life and may ask registrants to explain what factors were considered when making this determination.

Example SEC staff comment: Useful life determination – indefinite-lived intangible assets

Tell us how you determined that the acquired intangible assets from your acquisition of ABC Company was deemed to have an indefinite useful life. In your response, please tell us why you believe that no legal, regulatory, contractual, competitive, economic, expected use or other factors could limit the useful life of these intangible assets. We refer you to ASC 350-30-35-3.

Useful life determination and amortization method – customer-related intangibles

The SEC staff focuses on the useful life and amortization method of acquired finite-lived, customer-related intangible assets (e.g., customer lists, customer contracts, customer relationship intangibles). The SEC staff asks registrants to disclose how they determined the useful life of these assets and challenges such useful lives when the underlying assumptions do not appear consistent with customer information disclosed in other areas of the filing. The SEC staff also inquires about the amortization method chosen for these assets (e.g., straight-line versus accelerated) and requests that registrants explain their key assumptions about the expected future cash flows from an acquired customer-related intangible asset to support their chosen amortization method.

Example SEC staff comment: Amortization method – customer-related intangibles

We note that you amortize other intangible assets, including customer relationships, on a straight-line basis over their estimated useful lives of 20 years. Customer relationships generally dissipate at a more rapid rate in the earlier periods following a company’s succession to these relationships, with the rate of attrition declining over time. Under this pattern, a significant amount of cash flows derived from the acquired customer base may be recognized in earlier periods and then fall to a materially reduced level in later years. Please tell us why you believe that the straight-line method of amortization rather than an accelerated method reflects the pattern in which the economic benefits are consumed or explain why you cannot reliably determine the pattern in accordance with ASC 350-30-35-6.
Supplemental information on impairment analysis

An indefinite-lived intangible asset should be tested for impairment annually, or more frequently (in accordance with ASC 350) if events or changes in circumstances indicate that the asset might be impaired. The SEC staff may request that registrants explain how indefinite-lived intangible assets are tested for impairment, including the valuation method and significant assumptions used to determine the estimated fair values of the assets. As with goodwill impairment, the SEC staff challenges whether impairments of indefinite-lived intangibles should be recognized when the market capitalization or operating results of the registrant (or of the relevant segment) have declined significantly.

**EY resources**

Financial reporting developments, Intangibles – Goodwill and other (SCORE No. BB1499), July 2015

Financial reporting developments, Business combinations (SCORE No. BB1616), December 2014
Summary of issues noted

The SEC staff continues to question registrants’ disclosures in MD&A and the notes to the financial statements related to critical accounting policies, significant assumptions, and accounting and disclosures for plan amendments, settlements and curtailments.

Analysis of current issues

Critical accounting policies and significant assumptions

Recent SEC staff comments have asked registrants to disclose their policy elections when alternatives are available. The SEC staff requests robust disclosures of significant assumptions underlying defined benefit costs and obligations (e.g., discount rate, expected long-term rate of return on plan assets, and mortality).

Because registrants can make policy elections on the accounting for defined benefit pension and other postretirement benefit plans, the SEC staff expects them to provide clear disclosures about their accounting policies and elections. Examples include:

- Whether the expected return on plan assets is determined using fair value or a calculated value, and if a calculated value is used, how that value is determined
- The period and methodology used to amortize actuarial gains and losses and, if a “corridor” approach is used, which methodology was used to determine it

Further, the SEC staff expects registrants to disclose qualitative and quantitative analyses of changes in significant assumptions that materially affect their financial statements. Generally, if any significant assumption has changed or is expected to change in the future, and the effect in future periods will be material, the SEC staff expects the registrants to provide robust MD&A discussion and analysis of the reasons for the change and its effects.

Example SEC staff comment: Critical accounting policies and significant assumptions

In future filings, please include a qualitative and quantitative analysis of the sensitivity of reported results to changes in your assumptions, judgments, and estimates, including the likelihood of obtaining materially different results if different assumptions are applied. For example, if reasonably likely changes in the discount rate or long-term rate of return used in accounting for your pension plans would have a material effect on your financial condition or results of operations, the impact that could result given the range of reasonable outcomes should be disclosed and quantified.

In late 2014, the Society of Actuaries updated its mortality tables and improvement scale that form the basis for the mortality assumption of many companies. Consequently, the SEC staff has asked questions about the actual and future effects of those changes on registrants.
**Example SEC staff comment: Significant assumptions**

We understand that the Society of Actuaries developed an updated set of mortality assumptions presented in its RP-2014 Mortality Tables Report issued in October 2014. We also understand that the RP-2014 mortality tables represent the most current and complete benchmarks of US private pension plan mortality experience. Please tell us what consideration you gave to changing the mortality table used to calculate the present value of pension and postretirement plan liabilities. If you did not adopt the new mortality assumptions, please tell us the mortality table used to calculate the present value of pension and postretirement plan liabilities and why you believe the mortality rate assumptions reflect the best estimate of expected mortality rates for your participant population. If you adopted the RP-2014 mortality tables, please tell us the impact on pension and other postretirement plan liabilities.

**Plan amendments, settlements and curtailments**

The SEC staff also has focused on plan sponsors’ accounting and disclosures for plan amendments, settlements and curtailments. Plan sponsors may need to remeasure both plan assets and benefit obligations during the fiscal year when a significant event such as a plan amendment, settlement or curtailment occurs. Subsequent accounting for the plan should be based on the new measurements.

The SEC staff has sought clarification from entities that materially amended, settled or curtailed their defined benefit plans when there was no apparent adjustment to benefit costs or obligations. In addition, ASC 715-20-50 requires a reconciliation of beginning and ending balances of the benefit obligations and the fair value of plan assets, which typically include the effects of plan amendments, settlements and curtailments.

**Example SEC staff comment: Plan amendments, settlements and curtailments**

We note that you froze participation and future benefit accruals for certain employees. Please clarify whether this qualified as a plan curtailment or amendment, and explain why there is no adjustment to your benefit obligation or net benefit cost calculations attributable to a plan amendment or curtailment.

**EY resources**

- Compendium of significant accounting and reporting issues, 2013 AICPA National Conference on Current SEC and PCAOB Developments (SCORE No. CC0384), 16 December 2013
**Revenue recognition**

Gross versus net presentation

*Summary of issues noted*

The SEC staff continues to question how registrants determine whether to present revenue on a gross or net basis. Notably, the SEC staff is interested in understanding the analysis performed by registrants to support their conclusion that gross or net revenue reporting is appropriate.

*Analysis of current issues*

In many revenue arrangements, a registrant may assist a supplier in the fulfillment of its obligations to deliver goods or services to a customer (e.g., it may ship goods to and bill the customer on behalf of a supplier). In these circumstances, the registrant must determine whether it should report revenue based on (1) the total amount billed to the customer (i.e., gross) because, acting as a principal, it has earned revenue from the sale of the goods or services or (2) the net amount the registrant retains (i.e., the amount billed to a customer less the amount paid to the supplier) because, acting as an agent, it has earned a commission or fee. The objective is to determine whether the registrant is in substance acting as the principal that holds substantially all of the risks and benefits related to the sale of a product or service or, alternatively, the registrant is acting as an agent on behalf of another party (e.g., the supplier).

The guidance on principal and agent considerations in ASC 605-45 applies to revenue transactions in all industries, unless specific guidance is provided in other authoritative literature. The guidance does not provide any bright lines to determine whether gross or net presentation is appropriate. Rather, it provides indicators suggesting gross or net reporting that often require registrants to apply considerable judgment based on their specific facts and circumstances. While certain indicators are weighted (i.e., strong or weak), no single indicator is presumptive or determinative, and all of the indicators should be analyzed in their totality to determine whether the preponderance of evidence supports gross or net revenue reporting.

*Example SEC staff comment: Gross versus net presentation*

We note from your disclosure that you act as a middleman connecting suppliers and buyers for your wholesale goods. In addition, it appears from your disclosure that revenue you earn is the difference in the price you pay to suppliers and the price for which you sell to buyers and the product is shipped directly to the buyer by the supplier. Please provide us with a detailed discussion of your revenue recognition under the guidance of FASB ASC 605-45, including your analysis of each of the criteria therein.

Existing guidance largely has been written in the context of tangible goods, making its application to service transactions and virtual goods transactions more challenging and subject to greater judgment. Consequently, registrants in service and technology industries that do not carry inventory may be more likely to receive questions from the SEC staff about gross versus net determinations.
The SEC staff requests that registrants provide their analyses of each of the indicators identified in ASC 605-45 to support their conclusions on gross or net revenue reporting. Many of these analyses require significant judgment based on the facts and circumstances of a registrant’s arrangement with its customer(s). It is important that the facts and circumstances considered are complete and consistent with other information that is relevant to the analysis, including what might be found in customer contracts, marketing materials and on a registrant’s website. The analysis should be kept up to date.

It also is important for registrants to maintain thorough and contemporaneous documentation to support the conclusions made in analyzing these indicators and to perform the analysis for each type of revenue arrangement. It is not uncommon for a registrant to act as a principal in one arrangement, whereby gross revenue presentation is appropriate, while acting as an agent in another arrangement, which would require net revenue reporting.

**EY resources**

*Compendium of significant accounting and reporting issues, 2014 AICPA National Conference on Current SEC and PCAOB Developments (SCORE No. CC0405), 15 December 2014*
Summary of issues noted
The SEC staff may ask registrants whether they have appropriately considered and included in their accounting policies note all of the disclosures required by the multiple-element arrangements guidance. The SEC staff also asks registrants to discuss whether the multiple-element arrangements guidance is applicable to their transactions.

Analysis of current issues
Many registrants provide multiple products or services (deliverables) to their customers as part of a single arrangement. These arrangements may range from relatively simple ones for the delivery of multiple products on a single date (e.g., when a retailer sells a personal computer and printer to a customer and delivers them together) to more complex ones with multiple elements delivered over differing periods (e.g., a vendor provides and installs customized equipment and agrees to run it on an outsourced basis for an extended period).

The SEC staff often comments on the following areas:

- Identifying multiple-element arrangements
- Determining units of accounting
- Accounting policy disclosures

Identifying multiple-element arrangements
The multiple-element guidance generally applies to all registrants in all industries. As registrants expand their product and service offerings to meet customer demands, they may combine multiple elements in transactions with customers. The SEC staff may request that registrants explain or provide further analysis about whether the guidance on multiple-element arrangements applies to these transactions. In addition, when a registrant discloses it has multiple-element arrangements, the SEC staff may ask about specific goods or services within those arrangements, and whether they are considered deliverables that should be accounted for separately.

Example SEC staff comment: Identifying multiple-element arrangements
Please tell us whether your arrangements contain multiple elements and, if so, how your revenue recognition policy disclosures address these arrangements.

Registrants should monitor whether products and services accounted for historically as a single-element arrangement have become arrangements that include multiple deliverables subject to the guidance in ASC 605-25. Registrants also should consider periodically revisiting their analyses of multiple-element arrangements to determine whether they have appropriately identified the separable deliverables.

Determining units of accounting
The multiple-element guidance requires deliverables within an arrangement to be accounted for as separate units of accounting if they meet the separation criteria in ASC 605-25-25-5. One of the criteria is that the deliverable must have standalone value to the customer.
The SEC staff has requested that registrants provide an analysis supporting their determination that each deliverable accounted for separately has standalone value. However, the SEC staff has not limited its inquiry to registrants that have concluded that standalone value exists. The SEC staff also may request explanations about whether combined elements should be separated because one or more of the deliverables has value to the customer on a standalone basis.

**Example SEC staff comment: Separation criteria**

Please provide us your analysis demonstrating how each identified unit of accounting had standalone value based on the requirements of ASC 605-25-25-5a. For each deliverable identified as a separate unit of accounting, please state the factors that support or do not support a determination that the deliverable has value to the customer on a standalone basis, and explain the judgment used to reach the final determination.

Registrants should carefully evaluate the criteria for demonstrating standalone value (i.e., the item(s) are sold separately by any vendor or the customer could resell the delivered item(s) on a standalone basis), which could require considerable judgment. Thorough and contemporaneous documentation of that analysis is critical in order to appropriately apply the separation guidance in ASC 605-25.

**Accounting policy disclosures**

The overall disclosure objective is to provide qualitative and quantitative information about the significant judgments and changes to those judgments affecting the timing or amount of revenue recognition. The SEC staff may request that registrants expand their disclosures to provide a detailed explanation of how the estimated selling price is determined, including a discussion of any factors, trends, inputs, techniques or assumptions used in the registrant’s analysis. Registrants also must disclose how consideration is allocated to the separate units of accounting within multiple-element arrangements.

**Example SEC staff comment: Overall disclosures**

Your multiple-elements arrangement disclosure appears to quote accounting literature, but does not provide specific qualitative and quantitative information about your revenue arrangements. Please refer to the guidance in ASC 605-25-50. Provide us with your proposed disclosures.

Registrants should review their disclosures to verify that they not only conform to the specific requirements of ASC 605-25-50-2 but also meet the overall objective discussed above.

**EY resources**

Sales incentives

Summary of issues noted
The SEC staff may ask registrants about how they account for incentive programs, especially when they record a portion of the incentives within expense rather than as a reduction to revenue. In addition, the SEC staff may ask registrants to disclose the amount of discounts or allowances and the corresponding effect that these incentives have on the results of operations, regardless of whether they are classified as an expense or reduction of revenue.

Analysis of current issues
Many registrants offer sales incentives, including discounts, rebates, price protection and promotional products to customers. Under ASC 605-50, consideration given to a customer is presumed to be a reduction to revenue, unless the vendor receives an identifiable benefit and can reasonably estimate the fair value of that benefit.

Example SEC staff comment: Sales incentives

Please provide us with a robust description of the types of sales incentives that you offer to your customers. Please disclose your accounting policy for each of these types of arrangements pursuant to ASC 605-50, including the statement of income line item where each type of arrangement is included.

Registrants should clearly disclose their accounting policies related to material sales incentives provided to customers. When there are new incentive programs or changes in their structure or participation rates, MD&A should include a discussion of the terms of the programs and their effect on operations, if material.
Identification and aggregation of operating segments and entity-wide disclosures

Summary of issues noted
The SEC staff has increased its focus on segment reporting and how registrants apply ASC 280, following its remarks at the 2014 AICPA Conference. Among the areas the staff focuses on are:

- How registrants identify operating segments
- How registrants aggregate operating segments
- Whether registrants provide appropriate entity-wide disclosures related to products and services, revenues attributable to individual foreign countries and revenues from major customers

Analysis of current issues
At the 2014 AICPA Conference, a senior SEC staff member indicated that the SEC staff will be taking a “refreshed approach” to reviewing segment disclosures and encouraged registrants to use a similar approach when reaching their conclusions on segment reporting. Some of the areas highlighted by the SEC staff at the AICPA Conference included (1) identification of the chief operating decision maker (CODM), (2) identification of operating segments and (3) the aggregation or combination of operating segments.

When reviewing segment reporting, the SEC staff considers public information available from registrant earnings calls, registrant websites and industry or analyst presentations. The SEC staff asks registrants to explain any perceived inconsistencies between how the business is described in public information and how it is described in their segment footnote. The SEC staff also has requested explanation when there are inconsistencies in the description of the business in other sections of a registrant’s public filings and its segment footnote. For example, the staff may challenge a registrant’s basis for identifying operating segments when using something other than its product or service lines (e.g., geography) when publicly disclosed information indicates that its management uses financial information by product or service lines to make decisions and allocate resources.

The SEC staff expects registrants to continually monitor business developments. The staff may inquire about changes in the business that could affect the identification or aggregation of operating segments.

While the SEC staff has historically commented on segment reporting, we have noticed an increased focus in this area since the 2014 AICPA Conference. The staff may inquire about segment conclusions in a variety of circumstances, including when there are changes in the business and even when the staff has previously commented on a registrant’s segment reporting. Questions on segment reporting may often result in multiple rounds of comments, particularly when the registrant’s initial response is not comprehensive. The review process also may lead to requests for a teleconference with the SEC staff, including representatives of the SEC’s Office of the Chief Accountant.
Identification of operating segments

The segment reporting guidance is conceptually based on a “management approach” (ASC 280-10-5). That is, segment disclosures should be consistent with a registrant’s internal management reporting structure to enable investors to view the registrant similarly to the way management does. Registrants should challenge any conclusions they reach on operating segments that are not consistent with the basic organizational structure of their operations. To support the management approach concept, the SEC staff requests that registrants include a discussion of their internal structure or an organization chart and the processes used to make resource allocation decisions in their comment letter response.

Identifying operating segments (ASC 280-10-50-1 through 50-9) is the first step in preparing segment disclosures. A critical element of this analysis is identifying the CODM. Under ASC 280, the CODM represents a function, not necessarily a manager with a specific title. The SEC staff has said that a registrant should focus on who makes the key operating decisions in the organization and not default to who makes the strategic decisions or has the ultimate decision making authority. That is, the registrant should not default to the CEO when determining the CODM.

To evaluate a registrant’s identification of operating segments, the SEC staff often requests a description of the registrant’s organizational structure and detailed information about segment managers, including their roles and responsibilities and interactions with the CODM. The SEC staff also considers the basis on which budgets and forecasts are prepared and how performance objectives are evaluated, including how executive compensation is determined (e.g., performance criteria underlying compensation plans). This information allows the SEC staff to challenge whether the identified operating segments are consistent with the process by which performance is assessed and resource allocation decisions are made.

In certain situations, the SEC staff may request copies of the discrete financial information provided to a registrant’s CODM to understand the information used by the CODM to assess performance and make operating decisions. However, the staff recently clarified that the inclusion of information in a reporting package would not be the only factor considered in its assessment of identified operating segments.

Further, when a registrant identifies only one operating segment, the SEC staff may challenge how decisions can be made about performance and resources for the company as a whole without evaluating discrete financial information at lower levels.
Example SEC staff comment: Identification of operating segments

Please tell us who your chief operating decision maker (CODM) is and provide us with your analysis in determining the CODM. As part of your response, please provide us with an organizational chart that includes the titles and roles of the individuals who report directly to the CODM. In doing so, specifically explain to us the responsibilities of these individuals and the manner in which they typically interact with the CODM. In addition, please respond to the following:

- Describe the process through which your CODM reviews performance and makes decisions about the allocation of resources.
- Please elaborate on your budget process and tell us the methodology used to prepare the operating budget (e.g. top-down approach or bottom up approach), who approves the budget (including intra-period changes) and the nature of communications that address budget variances, including when and how the CODM is informed of these variances.
- Provide us with a detailed discussion of the financial and nonfinancial performance metrics utilized by the company to determine compensation for the CODM and segment managers.

Identifying operating segments also affects goodwill impairment testing. As discussed in the Goodwill section of this publication, the SEC staff may request information about the registrant’s determination of its reporting units. Incorrectly identifying operating segments may result in more reporting units and trigger additional goodwill impairment testing and recognition.

For further discussion on goodwill impairment testing, please refer to the Goodwill section of this publication.

Aggregation of operating segments

ASC 280 allows, but does not require, operating segments to be aggregated for reporting purposes. To be eligible to aggregate operating segments, a registrant must determine whether those operating segments meet certain criteria (ASC 280-10-50-11), which are a high hurdle in the SEC staff’s view. There are three key aggregation criteria, all of which must be met and require the use of judgment:

- The aggregation must be consistent with the objective and basic principles of ASC 280.
- The operating segments must be economically similar.
- The operating segments must have similar characteristics.9

9 In addition to being economically similar, operating segments must be similar in all of the following five qualitative areas: (1) nature of the products and services, (2) nature of the production processes, (3) type or class of customer for their products and services, (4) methods used to distribute their products or provide their services and (5) the nature of the regulatory environment, if applicable (ASC 280-10-50-11).
To be consistent with the objective and basic principles of ASC 280, the aggregation should help users make better-informed judgments about the registrant by improving their understanding of the registrant’s performance and assessment of the prospects for future net cash flows. That is, operating segments may be aggregated only if reporting them separately will not add significantly to the investor’s understanding of the entity because their characteristics are so similar that they can be expected to have essentially the same future prospects. As a result, it's important to understand that while the identification of operating segments follows a management approach, the aggregation of operating segments should be viewed through the lens of investors.

ASC 280 requires that aggregated operating segments have “similar economic characteristics,” such that they would be expected to have similar long-term financial performance. The similarity of the economic characteristics should be evaluated based on both current performance and future projections (ASC 280-10-55-7A). The SEC staff often reviews the registrant’s website, analyst presentations and information in public filings and questions inconsistencies with the registrant’s conclusion that operating segments can be aggregated based on similar economic characteristics. For example, a discussion of diverging trends or differing results among business lines could indicate that operating segments may not be economically similar.

During the comment letter process, the SEC staff may request historical and projected operating margins, gross margins, revenues and other measures of operating performance when challenging the aggregation of operating segments.

When a registrant has aggregated operating segments into a reportable segment, the staff frequently asks it to explain how the operating segments are similar in each of the other characteristics identified in ASC 280. For example, the SEC staff will seek to better understand how the registrant evaluates similarity across operating segments, considering the range of consolidated activities and product or service offerings. That is, while a registrant with a diversified product portfolio may consider certain products to be similar, those same products for a registrant with a more narrow range of activities may not be considered similar. The SEC staff also focuses on whether customers are similar across aggregated operating segments, particularly when products or services are targeted to a different customer base or when one of the operating segments has an incremental customer base with a material revenue stream.

**Example SEC staff comment: Aggregation of operating segments**

You disclosed that you meet the aggregation criteria pursuant to ASC 280 to report a single reportable segment. The discussion in your business section appears to indicate that you manage your business along product lines. Please clarify for us if product lines represent your operating segments. If so, please tell us how you evaluated that aggregation of the product lines was consistent with the objective and basic principles of ASC 280 and the product lines have similar economic characteristics. Please provide us with a detailed analysis of how you evaluated each of the aggregation criteria in ASC 280-10-50-11 in determining you have one reportable segment.
Ongoing assessment of reportable segments

The SEC staff has challenged registrants’ identification and aggregation of operating segments when there have been changes to the business. We believe this is linked to the SEC staff’s emphasis on registrants having processes in place to continuously reassess their conclusions because circumstances may change over time. For example, the SEC staff may want to understand how a change in a registrant’s internal reporting due to a significant acquisition or changes in performance among operating segments affected segment reporting conclusions.

Example SEC staff comment: Identification and aggregation of operating segments including a recent acquisition

We note your disclosure that you have determined it appropriate to aggregate your operating segments into one reportable segment. Please tell us the consideration given by management in determining your reportable operating segments in light of the acquisition of XYZ Company (XYZ), which operates in a different region of the country. We note from XYZ’s website that it appears to continue to operate as a separate entity under the XYZ name. In this regard, please tell us how you considered these characteristics of XYZ’s operations in determining that it is appropriate to present one reportable segment. Your response should address how you identified the operating segments under ASC 280-10-50-1 and 280-10-50-3 through 50 and further, how you evaluated each of the aggregation criteria in ASC 280-10-50-11.

Disclosure of factors used to identify reportable segments

ASC 280-10-50-21 requires registrants to disclose the factors used to identify their reportable segments, including whether operating segments have been aggregated. If not explicitly stated within the segment footnote, the SEC staff asks registrants whether they have aggregated operating segments when determining reportable segments and asks them to expand their disclosure in future filings.

Entity-wide disclosures

Disaggregated revenue by product and service

As part of the entity-wide disclosures, ASC 280 requires a registrant to disclose the amount of revenues derived from transactions with external customers for each product or service or each group of similar products or services, if not already provided as part of the reportable operating segment information required by ASC 280. Entities that have only one reportable segment also would be required to disclose revenues from transactions with external customers for each product or service or each group of similar products or services. For example, a registrant that sells consumer products and provides services would be required to disclose the revenues from each significant product line or service in its segment disclosure.

During the comment letter process, the SEC staff often requests that registrants that have not disclosed disaggregated revenue information do so or provide an explanation why such disclosure was not necessary. The SEC staff challenges the absence of such disclosure when the registrant’s publicly disclosed information indicates that its reportable segments contain a range of different products or services.
Example SEC staff comment: Disaggregated revenue by product

Please revise to disclose revenues from external customers for each product and service or each group of similar products and services. As part of your response, please describe the similarities and differences between the products and services presented as a group. Please refer to ASC 280-10-50-40.

Disaggregated revenue by geography

ASC 280 requires a registrant to disclose certain revenue information attributed to the registrant’s country of domicile and attributed to foreign countries. A registrant also is required to provide the geographic information by individual foreign country (ASC 280-10-50-41(a)), if material.

The SEC staff asks a registrant to disclose revenues attributed to specific foreign countries in light of its other disclosures about foreign locations.

Revenue contributed by significant customers

ASC 280-10-50-42 requires the disclosure of the total amount of revenues from each major customer (contributing 10% or more of total revenues) and the identity of the segment(s) reporting the revenues.

The SEC staff requests that registrants disclose such information when other disclosures indicate that there may be a concentration of sales to a particular customer.

EY resources

Compendium of significant accounting and reporting issues, 2014 AICPA National Conference on Current SEC and PCAOB Developments (SCORE No. CC0405), 15 December 2014

Financial reporting developments, Segment reporting – Accounting Standards Codification 280 (SCORE No. BB0698), June 2015
Discounts for post-vesting restrictions

Summary of issues noted
The SEC staff has challenged the basis for determining illiquidity discounts in the valuation of share-based payments with post-vesting restrictions and asked about the objective and verifiable evidence used to support the assumption.

Analysis of current issues
Some companies include a discount for illiquidity in the valuation of a share-based payment with post-vesting restrictions. For example, a share-based payment may prohibit an employee from selling shares for a specified period of time after vesting. While restrictions related to vesting are not included in the grant-date fair value of a share-based payment, restrictions in effect after vesting are considered when estimating the grant-date fair value based on ASC 718-10-30-10. However, ASC 718-10-55-5 states that if shares are traded in an active market, post-vesting resale restrictions may have little, if any, effect on the value of those shares.

If a registrant applies a discount without disclosing the basis for that assumption, the SEC staff may challenge the basis for determining the discount, including the objective evidence used to support the discount. Objective evidence should consider the effects of all relevant terms of shares that have similar, but not identical characteristics, as the shares traded in a public market.

When valuing share-based payment awards with post-vesting restrictions, the assumptions used should be attributes that a market participant would consider (i.e., inherent attributes of the security), and not attributes that are specific to the holder of the security. Therefore, any illiquidity discount should be specific to the security and not derived based on subjective evidence. Valuations based solely on the studies of market price discounts used in other circumstances normally would not be considered objective and verifiable evidence.

Example SEC staff comment: Discounts for post-vesting restrictions
Please tell us your basis for applying a 25 percent discount to the fair value of your common stock to estimate the fair value of restricted shares issued to directors, and why the percent discount is considered reasonable under the circumstances. In doing so, please tell us your consideration of ASC 718-10-55-5 which states that, “if shares are traded in an active market, post-vesting restrictions may have little, if any, effect on the amount at which the shares being valued would be exchanged.”

EY resources
Financial reporting developments, Share-based payment (SCORE No. BB1172), July 2015
We analyze trends in SEC staff comment letters related to the airlines industry. The following table summarizes the topics the SEC staff focused on most often in comment letters sent to registrants in the airlines industry. These topics are frequent areas of comment in letters received by registrants in other industries and are covered in the rest of this publication.

<table>
<thead>
<tr>
<th>Comment area</th>
<th>Comment rank for the 12 months ended 30 June*</th>
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<tbody>
<tr>
<td>Management’s discussion and analysis</td>
<td>1</td>
</tr>
<tr>
<td>Income taxes</td>
<td>2</td>
</tr>
<tr>
<td>Pro forma financial information</td>
<td>3</td>
</tr>
<tr>
<td>Intangible assets and goodwill</td>
<td>4</td>
</tr>
<tr>
<td>Revenue recognition</td>
<td>5</td>
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* Based on comment letter topics assigned by research firm Audit Analytics for SEC comment letters issued to registrants related to Forms 10-K

** This topic wasn’t in the top 10 comment areas in 2014.

We did not identify comment areas unique to registrants in the airlines industry during the current year. However, the SEC staff previously has focused on the following topics, which may be areas of focus in the future:

- **Accounting for frequent flyer programs** – The SEC staff has asked registrants to explain certain aspects of their accounting for frequent flyer programs (e.g., co-branded credit card arrangements) and provide additional disclosures about changes in frequent flyer programs.

- **Definite- and indefinite-lived long-term assets** – Given the industry’s capital intensive nature, many airlines have significant tangible assets (property and equipment) and intangible assets (goodwill, slots, routes). The SEC staff has asked registrants to explain changes in assumptions about the recoverability and the useful lives of those assets.

- **Power-by-the-hour (PBTH) maintenance agreements** – The SEC staff has asked registrants about their accounting for PBTH contracts, in particular focusing on whether they have appropriately considered whether the airline has transferred the risk to the third-party service provider and in turn is recognizing maintenance expense appropriately.

- **Maintenance deposits** – The SEC staff has asked registrants to provide further disclosure about the significant judgments and estimates involved in assessing the recoverability of maintenance deposit assets held by aircraft lessors for future qualifying maintenance activities.

Refer to the Airlines supplement to the 2014 SEC Comments and Trends publication for further discussion of these topics.
Banking supplement

In this supplement, we analyze trends in SEC staff comment letters related to the banking industry. The following table summarizes the topics the SEC staff focused on most often in comment letters sent to registrants in the banking industry. Many of these topics are frequent areas of comment in letters received by registrants in other industries and are covered in the rest of this publication.

<table>
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<tr>
<td></td>
<td>2015</td>
</tr>
<tr>
<td>Loans receivable – valuation and allowance</td>
<td>1</td>
</tr>
<tr>
<td>Management's discussion and analysis</td>
<td>2</td>
</tr>
<tr>
<td>Fair value measurements**</td>
<td>3</td>
</tr>
<tr>
<td>Executive compensation disclosures</td>
<td>4</td>
</tr>
<tr>
<td>Signatures, exhibits and agreements</td>
<td>5</td>
</tr>
</tbody>
</table>

* Based on comment letter topics assigned by research firm Audit Analytics for SEC comment letters issued to registrants related to Forms 10-K

** This category includes SEC staff comments on fair value measurements under ASC 820 as well as fair value estimates, such as those related to revenue recognition, stock compensation and goodwill impairment analyses. Individual SEC staff comments may be associated with more than one comment area in this chart.

The following industry supplement focuses on comment areas that are unique to registrants in the banking industry. The supplement should be read in conjunction with the topics in the main section that also may contain relevant information to registrants in the banking industry.

In its comments, the SEC staff may request additional information about a topic and compliance with SEC rules or accounting literature. However, the SEC staff comments are based on the registrant's facts and circumstances, including judgments about materiality. This supplement can help companies identify the SEC staff's areas of focus, but registrants should also consider significance to investors when including disclosure in their filings.
Lending activities (including the allowance for credit losses)

Summary of issues noted
The SEC staff may ask banking industry registrants to provide more information about lending activities and the related allowance for credit losses. Credit quality indicators, reversals of the allowance, appraisals, segmentation, non-performing loans and troubled debt restructurings (TDRs) are among the SEC staff’s areas of focus.

Analysis of current issues
Credit quality indicators
The SEC staff continues to comment on the sufficiency of credit quality disclosures in the notes to the financial statements. The SEC staff is particularly alert when the allowance changes are inconsistent with the changes in key credit metrics. The staff may request, among other things:

- Additional discussion of the changes in key credit metrics/ ratios (e.g., allowance to charge-off ratio, allowance to total loans, allowance to nonperforming loans) and migration in past dues when there appears to be directional inconsistency with narrative disclosures
- Additional discussion of the changes or lack of changes in qualitative components of the allowance when the registrant also discloses improvement in economic conditions
- Additional discussion of how changes in model assumptions affect the allowance, including changes in the loss emergence period and look back period
- Additional discussion of changes in underwriting and lending policies
- Additional granularity about changes in trends of the underlying credit risk of loans collectively evaluated

Example SEC staff comment: Credit quality indicators
Tell us why your allowance of 12 times charge-offs over the last three years is appropriate given your statement that market conditions have improved in the geography of your loan portfolios during the year.

Reversals of the allowance for credit losses
As a result of improved economic conditions over the past few years, some financial institutions are reversing previously recorded allowances now that the creditworthiness of underlying receivables has improved. The SEC staff may ask registrants to provide more information about reversals, including:

- When the reversals were taken and why
- The reason behind changes in internal or external qualitative factors
- Performance of specific loan pools (e.g., reductions in nonperforming loans)
- Any significant trends (e.g., economic factors, credit risk, loan growth)
Use of collateral appraisals

The SEC staff may ask registrants to disclose and clarify their policies for measuring both impairment of a loan when measurement relies on an estimate of the value of the underlying collateral and also the value of foreclosed assets (also referred to as other real estate owned or OREO). Often, the value of collateral is supported by an appraisal. Specific staff comments in this area request that registrants provide more information on the following:

- Disclosure of the amount of loans that are collateral-dependent for which the registrant is using the appraised value for the specific reserve calculation of impaired loans
- How the appraisals are validated and whether (and why) any adjustments are made to the appraiser’s conclusion
- If an “evaluation” is used instead of an “appraisal,” disclosure of the policies and procedures for performing the evaluation, as well as quantification of the loans evaluated

Loan segmentation

The SEC staff may ask registrants to provide additional disclosures in the notes to the financial statements and MD&A regarding loan segmentation. The staff may request, among other things:

- Policies and procedures for underwriting loans by loan portfolio category, lending within each category and by major loan products within each category
- Discussion of why a lending segment that makes up greater than 10% of assets is not reported as a separate operating segment
- Risks and uncertainties inherent in various loan types, noting which are higher risk or have unique risks and whether the registrant engages in subprime lending
- Percentage of total loans for each loan type, noting material changes or trends
- Maturity and rate sensitivity disclosures for newly material loan pools

Example SEC staff comment: Loan segmentation

Please include a complete description of your loan underwriting policies and procedures for each loan category and each major loan type within each category, as appropriate. Also, please expand the footnotes to the financial statements to discuss the risks and uncertainties surrounding your receivables. Refer to ASC 310-10-50-11B(a)2.
**Non-performing, past dues and TDRs**

The SEC staff may ask registrants to provide additional disclosures about past due receivables and TDRs (particularly when there are significant migrations in past dues or significant restructurings), including:

- Additional disaggregation of days-past-due disclosures (e.g., further disaggregation of 30–89 days past due into 30–59 and 60–89 and disaggregation by loan category)
- Additional discussion of the underlying characteristics of the loan portfolios when non-performing loans move in a direction opposite that of TDRs and impaired loans
- Rationale for removing disclosures (e.g., whether the registrant believed they were no longer relevant to understanding credit risk trends in certain portfolios)
- Additional discussion of significant modifications and renewals and the registrant’s policies for determining TDRs under ASC 310-40-15, as well as returning to accruing status after modification
- Quantification of the number and amount of loans with multiple renewals when renewals are significant, as well as the resulting effect on loan loss models
- Clarification whether loans past due 90 days or more and still accruing are included in total nonperforming loans, and whether performing TDRs are included in nonperforming loan tables and corresponding asset quality ratios

**Example SEC staff comment: Non-performing, past dues and TDRs**

Provide additional disclosures to more clearly define and quantify the individual nonperforming loan components. Additionally, please separately present the aggregate amounts of loans in each of the following categories for the period presented:

(a) Loans accounted for on a nonaccrual basis;
(b) Accruing loans which are contractually past due 90 days or more as to principal or interest payments; and
(c) Loans not included in above which are TDRs. In this regard, provide a note to the tabular presentation to state the amount of nonaccrual TDRs included in (a).

**EY resources**

- Technical Line, *New troubled debt restructuring disclosures vary significantly* (SCORE No. BB2253), 4 January 2012
Summary of issues noted
The SEC staff continues to focus on the sufficiency of initial and ongoing credit quality disclosure for purchased loans, as a result of continued consolidation within the industry through business combinations and portfolio purchases.

Analysis of current issues
Accounting for purchased loans
The SEC staff may ask registrants for additional disclosures in the notes to the financial statements and MD&A related to acquired loans, such as:

- More information on the nature of the loans acquired and their specific risks
- Discussion of how the acquired loans affect credit ratios and trends, and comparability to prior periods
- Disaggregation of related allowance and credit quality disclosures (e.g., originated versus acquired loans; for acquired loans, disclosures for each significant acquisition, as well as purchase credit impaired (PCI) versus non-PCI; for PCI loans, the amount of loans accounted for in pools versus individually)
- Rollforward of the carrying value of acquired loans by repayments, foreclosures and changes in fair value
- Discussion of how acquired loans that were TDRs, impaired or are more than 90 days past due and accruing interest are classified at acquisition
- Discussion of significant changes or unusual trends in accretable and non-accretable yield, including material reclassifications between accretable and non-accretable yield and rationale for having high non-accretable yield with only performing loans remaining

Additionally, for registrants with loss share agreements (including those with the Federal Deposit Insurance Corporation (FDIC), many of which were entered into during the acquisitions of failed financial institutions during the financial crisis), the SEC staff has asked for a rollforward of the indemnification asset and how the changes correspond to specific line items in the income statement.

Example SEC staff comment: Accounting for purchased loans
Please discuss how your accounting for acquired loans impacts your credit metrics and trends. Specifically identify the credit metrics and trends most impacted (e.g., the allowance for credit losses as a percentage of loans) and discuss comparability between periods and with other institutions.
Parent Company disclosures – Statement of Cash Flows

**Summary of issues noted**
The SEC staff has challenged how line items are classified on the statement of cash flows in the parent company condensed financial information schedule.

**Analysis of current issues**
**Parent company disclosures – Statement of cash flows**
The SEC staff has commented on how the dividends received by the parent company were classified in the parent company-only disclosures. Specifically, the SEC staff has asked registrants to classify dividends received in the operating cash flows section of the parent company statement of cash flows when those dividends are received from wholly owned subsidiaries.

**EY resources**
Health care supplement

In this supplement, we analyze trends in SEC staff comment letters related to the health care industry. The following table summarizes the topics the SEC staff focused on most often in comment letters sent to registrants in the health care industry. Many of these topics are frequent areas of comment in letters received by registrants in other industries and are covered in the rest of this publication.

<table>
<thead>
<tr>
<th>Comment area</th>
<th>2015</th>
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<tbody>
<tr>
<td>Management’s discussion and analysis</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Acquisitions and business combinations</td>
<td>2</td>
<td>6</td>
</tr>
<tr>
<td>Debt, warrants &amp; equity security issues</td>
<td>3</td>
<td>7</td>
</tr>
<tr>
<td>Fair value measurements**</td>
<td>4</td>
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<tr>
<td>Non-GAAP financial measures</td>
<td>5</td>
<td>5</td>
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</table>

* Based on comment letter topics assigned by research firm Audit Analytics for SEC comment letters issued to registrants related to Forms 10-K

** This category includes SEC staff comments on fair value measurements under ASC 820 as well as fair value estimates, such as those related to revenue recognition, stock compensation and goodwill impairment analyses. Individual SEC staff comments may be associated with more than one comment area in this chart.

The following industry supplement focuses on comment areas that are unique to registrants in the health care industry. The supplement should be read in conjunction with the topics in the main section that also may contain relevant information to registrants in the healthcare industry.

In its comments, the SEC staff may request additional information about a topic and compliance with SEC rules or accounting literature. However, the SEC staff comments are based on the registrant’s facts and circumstances, including judgments about materiality. This supplement can help companies identify the SEC staff’s areas of focus, but registrants should also consider significance to investors when including disclosure in their filings.
The SEC staff may ask registrants to explain reasons for changes in their claims development trends.

**Summary of issues noted**

The SEC staff has asked registrants in the health care industry to explain how management has addressed favorable or unfavorable trends in claims experience on self-insurance or medical claims liabilities.

**Analysis of current issues**

The SEC staff may ask registrants to expand disclosures about self-insurance or medical claims liabilities, including estimated claims payable and incurred but not reported (IBNR) liabilities. For example, registrants may be asked to disaggregate the changes in these liabilities between claims incurred in the current year and changes to prior-year reserve estimates. If trends indicate significant favorable or unfavorable development, the SEC staff may ask a registrant to disclose the factors driving the changes in claims experience, and how management considered those trends in its reserve methodology.

**Example SEC staff comment: Accrued insurance claims**

Given the magnitude of the unfavorable development during the years presented, please tell us and disclose in future filings, the reasons for the unfavorable development and how management has addressed these changes in their reserving methodology. If appropriate, please include a discussion of any changes in the severity and/or frequency of claims that may have caused the unfavorable development.
Insurance supplement

In this supplement, we analyze trends in SEC staff comment letters related to the insurance industry. The following table summarizes the topics the SEC staff focused on most often in comment letters sent to registrants in the insurance industry. Many of these topics are frequent areas of comment in letters received by registrants in other industries and are covered in the rest of this publication.

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<tr>
<th>Comment area</th>
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<td>Fair value measurements**</td>
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<td>Loss reserves</td>
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<td>Management’s discussion and analysis</td>
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<tr>
<td>Intangible assets and goodwill</td>
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</table>

* Based on comment letter topics assigned by research firm Audit Analytics for SEC comment letters issued to registrants related to Forms 10-K
** This category includes SEC staff comments on fair value measurements under ASC 820 as well as fair value estimates, such as those related to revenue recognition, stock compensation and goodwill impairment analyses. Individual SEC staff comments may be associated with more than one comment area in this chart.

The following industry supplement focuses on comment areas that are unique to registrants in the insurance industry. The supplement should be read in conjunction with the topics in the main section that also may contain relevant information to registrants in the insurance industry.

In its comments, the SEC staff may request additional information about a topic and compliance with SEC rules or accounting literature. However, the SEC staff comments are based on the registrant’s facts and circumstances, including judgments about materiality. This supplement can help companies identify the SEC staff’s areas of focus, but registrants should also consider significance to investors when including disclosure in their filings.
Adequacy of casualty loss and loss adjustment expense reserves

Summary of issues noted
The SEC staff may challenge the adequacy of disclosures relating to property and casualty loss and loss adjustment expense reserves and may request additional information about the changes affecting the recorded reserve. The SEC staff frequently requests that registrants provide more information about the reasons that led to the change in estimate and why the change occurred in the current period rather than a previous period.

Analysis of current issues
The SEC staff comments address property and casualty loss and loss adjustment expense reserves and related disclosures including the registrant’s loss reserve rollforward disclosures. Registrants typically disclose in MD&A the methods used to estimate property and casualty loss reserves and changes in reserve estimates. These disclosures tend to provide general information about reserve development involving severity trends, reserve releases or strengthening.

The SEC staff requests that registrants disclose more specific information about changes in reserve estimates, both favorable and unfavorable, including identifying experience and information that caused actual experience to differ from what was expected and whether current trends are expected to continue. In addition, the SEC staff asks registrants to provide more detail about the key assumptions used by management, the variability in the key assumptions and the effect of such adjustments on the reserve estimates.

Example SEC staff comment: Property and casualty loss reserves
Please explain the reasons for changes in estimates related to property and casualty loss reserves. Address the following:

- Identify and describe the nature and extent of a) new events that occurred or b) additional experience/information obtained since the last reporting date that led to the change in estimates.
- Explain the timing of the change in estimate such as why recognition occurred in the periods that it did and why recognition in earlier periods was not required.

Statutory disclosures and dividend restrictions

Summary of issues noted
The SEC staff continues to issue comments to registrants in the insurance industry on the sufficiency of disclosures related to statutory and regulatory requirements in their financial statements under Rule 4-08(e) of Regulation S-X.

Analysis of current issues
The SEC staff continues to request that registrants disclose the nature of dividend restrictions at the parent and subsidiary levels and the amount of retained earnings or net income restricted or unrestricted for payment of dividends. In addition, when restricted net assets exceed 25% of consolidated net assets, Rule 4-08(e) requires additional disclosure to describe the nature of such restrictions and the amount of restricted net assets for subsidiaries as of the end of the most recently completed fiscal year. Refer to the Rule 4-08(e) disclosures section under SEC reporting issues in this publication for further discussion about these disclosure requirements.
Appendix A: Industry supplements

The SEC staff also has continued to challenge registrants’ compliance with disclosure requirements about statutory capital and surplus of insurance entities. For registrants with insurance subsidiaries that are material, these disclosure requirements include the following:

- Disclose the difference between US GAAP and statutory capital and surplus amounts for each balance sheet date presented
- Disclose the amount of statutory capital and surplus necessary to satisfy regulatory requirements or that the amount required is not significant in relation to actual statutory capital and surplus
- Disclose the statutory income or loss for each period for which an ending balance sheet is presented
- Provide the annual disclosures on an audited basis

**Example SEC staff comment: Statutory disclosures and dividend restrictions**

Provide us with the proposed disclosure, to be included in your notes to consolidated financial statements in future periodic reports that address the following:

- Disclose the amount of retained earnings or net income restricted or free of restrictions for the payment of dividends by the Corporation to its stockholders as required by Rule 4-08(e) (1) of Regulation S-X.
- Disclose the amounts of restricted net assets for your subsidiaries as of the end of the most recently completed fiscal year or tell us how your current disclosure complies with the objective in Rule 4-08(e) (3)(ii) of Regulation S-X.
- Provide the disclosures required under ASC 944-505-50-2 through 50-6, as applicable.

**Summary of issues noted**

The SEC staff has continued to ask insurance registrants to provide expanded disclosures about how low interest rates are expected to affect future financial position, cash flow and profitability of certain products.

**Analysis of current issues**

Specifically, the SEC staff may request information on how the low interest rate environment continues to place pressure on net investment income and how cash flows will be reinvested as investments mature or are called. In addition, the SEC staff may ask registrants about cash flows that are committed to pay guaranteed features that are due. The SEC staff also asks registrants to disclose information such as the amount of maturing or callable investments, their weighted average yields and insurance liabilities with minimum interest rate guarantees by product type.
In this supplement, we analyze trends in SEC staff comment letters related to the life sciences industry. The following table summarizes the topics the SEC staff focused on most often in comment letters sent to life sciences registrants. Many of these topics are frequent areas of comment in letters received by registrants in other industries and are covered in the rest of this publication.

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<td>Signatures, exhibits and agreements</td>
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<tr>
<td>Intellectual property risks and disclosures**</td>
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* Based on comment letter topics assigned by research firm Audit Analytics for SEC comment letters issued to registrants related to Forms 10-K

** This category includes SEC staff comments on risk factors and disclosures related to the nature, type and expiration of intellectual property agreements.

The following industry supplement focuses on comment areas that are unique to registrants in the life sciences industry. The supplement should be read in conjunction with the topics in the main section that also may contain relevant information to life sciences registrants.

In its comments, the SEC staff may request additional information about a topic and compliance with SEC rules or accounting literature. However, the SEC staff comments are based on the registrant’s facts and circumstances, including judgments about materiality. This supplement can help companies identify the SEC staff’s areas of focus, but registrants should also consider significance to investors when including disclosure in their filings.
Revenue recognition

Revenue deductions

Summary of issues noted

Revenue recognition is a main area of SEC staff focus for life sciences registrants. The staff may ask registrants to provide enhanced disclosure in their results of operations and critical accounting estimates sections of MD&A about items that reduce gross revenue (e.g., estimates of product returns, rebates, distributor chargebacks, distributor incentives).

Analysis of current issues

The judgments and assumptions that registrants often make when they estimate revenue deductions (e.g., product returns, rebates, chargebacks) have a material effect on their reported financial condition and operating performance and on the comparability of that information among reporting periods. The SEC staff may ask registrants to provide more robust disclosures in MD&A, including the following:

- More information about the nature and amount of each revenue deduction, along with information about the key terms of material arrangements or agreements that influence the estimate of each deduction as of each balance sheet date
- Rollforward information for each revenue deduction for each financial statement period presented, including the beginning and ending accrual balances, the current provision related to sales made in the current and prior periods (presented separately), and the actual returns or credits in the current period related to sales made in the current and prior periods (presented separately)
- More information about the qualitative factors that management considers when estimating each revenue deduction, including the following:
  - How management evaluates factors such as levels of inventory in distribution channels, estimated remaining product shelf lives, shipments of product made as a result of incentives, shipments in excess of the customers’ ordinary demand and introductions of new or generic competitive products
  - The extent, availability and use of information from external sources, such as end-customer prescription data from third parties, distributor inventory reports and third-party market research data comparing wholesaler inventory levels to end-customer demand
  - The underlying business reasons for material period-to-period fluctuations in each type of reduction of gross revenue, including the effect that changes in estimates had on revenues and obligations

Milestone method of revenue recognition

Summary of issues noted

The SEC staff continues to ask life sciences registrants to expand disclosures for each research and development (R&D) arrangement for which they recognize revenue from one or more milestone payments in accordance with ASC 605-28.
**Analysis of current issues**

Life sciences registrants often enter into arrangements to provide research or development deliverables in which one or more payments are contingent on the achievement of uncertain future events or conditions called milestones. Life sciences registrants may elect to recognize revenue in its entirety in the period in which the milestone is achieved, if the milestone meets all criteria to be considered substantive in ASC 605-28-25-2. The SEC staff may request that life sciences registrants provide further analysis about how they have accounted for milestone arrangements.

ASC 605-28-50-2(b) requires disclosures at the individual milestone level. As a result, the SEC staff may question the adequacy of disclosures about each arrangement and each milestone. Many registrants, especially those with multiple arrangements and numerous milestones within each arrangement, may prefer to include disclosures on an aggregated basis in an effort to improve their usefulness. While SEC staff comments and responses indicate that the staff believes disclosure of each milestone is required, it has not objected to aggregated disclosures in certain cases. In these cases, registrants have asserted that individual milestones are not material, and information on an aggregated basis would be more useful to users of the financial statements.

**Example SEC staff comment: Milestone method of revenue recognition**

Please provide the disclosures required under paragraphs b – d of ASC 605-28-50-2. Specifically disclose individually material milestones and provide the required disclosures on a combined basis for milestones that are not individually material, but are material in the aggregate, in a manner which assists users in understanding this arrangement.

**EY resources**

Technical Line, Aggregating milestone method disclosures may sometimes be appropriate (SCORE No. BB2264), 12 January 2012

**Multiple-element arrangements**

**Summary of issues noted**

The SEC staff may ask registrants to expand their accounting policy disclosures about multiple-element arrangements, including those required by ASC 605-25-50-2.

**Analysis of current issues**

**Required disclosures**

Life sciences registrants often enter into revenue arrangements with counterparties that include multiple elements, such as licensing intellectual property, R&D services, manufacturing services and commercialization activities. The consideration received under these arrangements can be significant and often is the primary source of revenue for life sciences registrants without commercial products of their own.
Because of the unique nature of the products and services underlying these arrangements, the significance of the consideration transferred and the level of judgment involved in determining the appropriate accounting, the SEC staff may request that registrants include additional information in their disclosures about multiple-element arrangements, including the following:

- Description of the obligations and rights under the agreement
- Whether each deliverable does or does not represent a separate unit of accounting
- The amount of the total arrangement consideration and the arrangement consideration allocated to each unit of accounting
- How the estimated selling price for each unit of accounting was determined

These disclosures should provide both quantitative and qualitative information about significant judgments (and changes in those judgments) made by registrants in applying the multiple-element guidance and address the specific requirements of ASC 605-25-50-2.

**Example SEC staff comment: Multiple-element arrangement disclosures**

We note that you have certain customer agreements that are considered multiple element arrangements. Please tell us how you considered the disclosures required by ASC 605-25-50, including the requirement to disclose the nature of the arrangement, the significant deliverables within the arrangement and the general timing of delivery or performance of the service for the deliverables.

**Identifying multiple-element arrangements**

The SEC staff may request that life sciences registrants provide further analysis about specific items in a transaction, discussing whether those items are considered deliverables that should be accounted for separately. For example, the staff has requested additional analysis about the following:

- Transfer of a license to a product candidate
- R&D services
- Manufacturing and supply agreements
- Participation in joint steering or development committees

**Example SEC staff comment: Identifying multiple-element arrangements**

In your evaluation of deliverables, how did you consider the obligations of each of your committees (i.e., joint steering committee and joint development committee)? Are these obligations considered a deliverable? Why or why not?
Summary of issues noted

The SEC staff frequently requests that registrants expand their disclosures about collaboration arrangements to include a discussion of the overall nature of the arrangements, the amounts and factors affecting payments that registrants may receive or be required to make under the arrangement (e.g., milestone or royalty payments), and the accounting policies related to their collaboration agreements. Further, when such an agreement appears to be material, the staff may request that the registrant file it as an exhibit to the SEC filing or, alternatively, provide an analysis supporting the determination that the agreement is not required to be filed as a material exhibit under Item 601 of Regulation S-K.

Analysis of current issues

Disclosures

ASC 808-10-50-1 requires a registrant to provide the following disclosures in the period in which a collaboration agreement is entered into and all subsequent annual periods:

- Information about the nature and purpose of its collaboration arrangement
- Its rights and obligations under the collaboration agreement
- The accounting policy for collaboration agreements in accordance with ASC 235
- The income statement classification and amounts attributable to transactions arising from the collaboration arrangement between participants for each period an income statement is presented

When collaborations are material (either individually or in the aggregate), the staff has asked registrants to provide a table that shows total amounts attributable to collaborations for each balance sheet and income statement line item for each period presented. In some circumstances, the staff has asked registrants to disclose the table in the financial statements.

Example SEC staff comment: Collaborations

Provide us proposed disclosure to be included in future periodic reports that describes your policy for separation and allocation of the elements of collaboration arrangements with multiple elements.

Confirm to us that you will include in future periodic reports a table showing the total of amounts attributable to your collaborations by consolidated balance sheet and statement of earnings line item as of and for each period presented. Provide us proposed disclosure that shows the format of this table.

For registrants with contingent payment obligations under collaboration arrangements, the staff has indicated that the contingent payments should be included either in the contractual obligations table or as a footnote to the table in MD&A if their occurrence is reasonably possible. If the contingent payments are not reasonably possible, the staff has asked registrants to disclose the reason(s) for excluding such payments from the table. See the Liquidity and capital resources section of this publication for further discussion of the contractual obligations table.
Exhibits

Item 601 of Regulation S-K contains instructions on filing exhibits and identifies the exhibits to be included in each SEC filing. For life sciences registrants, when disclosures in other parts of an SEC filing suggest a collaboration arrangement is material, but the agreement has not been filed as an exhibit, the SEC staff asks the registrant to explain why it is not “substantially dependent” on the arrangement. This determination is generally qualitative, and a registrant should consider all relevant facts and circumstances, including:

- Whether its future success depends on a successful development outcome for items covered by the arrangement
- The existence of other counterparties that would be able to fulfill the obligations required under the arrangement
- The existence of collaborative arrangements related to its other development projects
- The significance of the R&D arrangement to the overall development project

Summary of issues noted

The life sciences industry continues to see significant licensing and merger and acquisition activity. Many life sciences registrants are pursuing collaborations and licensing transactions, along with larger deals and smaller strategic acquisitions, to bolster their pipelines or market share. The SEC staff may request additional analysis from registrants to support their conclusions about whether certain transactions are business combinations.

Analysis of current issues

Transactions involving life sciences registrants can take many forms, including an outright acquisition of another entity or the acquisition or in-licensing of a product candidate. When a life sciences registrant obtains control of an acquired set of activities and assets, it must evaluate whether the acquired set constitutes a business. This evaluation is particularly important in this industry, since the conclusion can result in significantly different accounting results. For example, many life sciences transactions include in-process research and development (IPR&D) and potential contingent consideration, such as milestone and royalty payments. The accounting for IPR&D assets and contingent consideration under the business combination guidance can be significantly different than the accounting under other guidance.

When a registrant’s disclosure about the acquired assets and activities is unclear, the SEC staff may ask the registrant to explain how it evaluated whether the acquired set constitutes a business or an asset.

Example SEC staff comment: Business combinations

You indicate your intent to account for the acquisition of Target as an asset acquisition because you will acquire only inputs and will not acquire any processes. Please provide us your analysis supporting your conclusion that the acquisition of Target is not a business to be accounted for under the acquisition method of accounting.
Summary of issues noted
The SEC staff may challenge the adequacy of disclosures relating to patents and ask life sciences registrants to include in MD&A additional information about material patents that are owned, licensed or pending.

Analysis of current issues
Most life sciences registrants own, license or have applied for a large number of patents in the US and many other countries relating to products, product uses, formulations and manufacturing processes. The SEC staff may ask registrants that own or license a large number of patents to provide additional disclosures about the nature of those patents. Specifically, the SEC staff requests the following disclosures for material patents:

- A discussion of the products or technologies that relate to the patent
- The jurisdiction in which the patent is issued or pending
- The type of patent protection
- The expiration date
- Patents subject to legal proceedings
- Whether the patents are owned or licensed from third parties, and if so, from whom

The staff may ask registrants with multiple patents for a product or technology to disclose the above information by patent, or identify individual patents that have been aggregated for disclosure based on similar characteristics. In addition, the staff may ask registrants to disclose the nature of material pending patents, including a discussion of the products or technologies that relate to the pending patent and the jurisdiction of the patent application.

Summary of issues noted
The SEC staff may ask life sciences registrants to provide more detailed disclosures in MD&A about their material R&D activities. The staff focuses on the status of major R&D projects and the costs incurred to date, as well as the estimated completion dates, completion costs and capital requirements.

Analysis of current issues
Most life sciences registrants incur significant expense for R&D activities, and for some it may be the largest expense on the income statement.

If R&D expense is material, the SEC staff asks registrants to provide more specific MD&A disclosures about significant R&D projects, including:

- The nature, objective and current status of each project, and whether each project’s success depends on parties other than the registrant
- The costs incurred on each project during each period presented and to date
- The nature, timing and estimated costs of the efforts necessary to complete each project
- The anticipated completion dates of each project

The SEC staff may ask a registrant that does not track R&D costs by project to disclose its reasons for not doing so.
Appendix A: Industry supplements

Mining and metals supplement

In this supplement, we analyze trends in SEC staff comment letters related to the mining and metals industry. The following table summarizes the topics the SEC staff focused on most often in comment letters sent to mining and metals registrants. Many of these topics are frequent areas of comment in letters received by registrants in other industries and are covered in the rest of this publication.

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<th>Comment area</th>
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<td>Management’s discussion and analysis</td>
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<td>Mining reserves</td>
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<td>Fair value measurements***</td>
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<tr>
<td>Internal control over financial reporting</td>
<td>5</td>
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* Based on comment letter topics assigned by research firm Audit Analytics for SEC comment letters issued to registrants related to Forms 10-K
** This topic wasn’t in the top 10 comment areas in 2014.
*** This category includes SEC staff comments on fair value measurements under ASC 820 as well as fair value estimates, such as those related to revenue recognition, stock compensation and goodwill impairment analyses. Individual SEC staff comments may be associated with more than one comment area in this chart.

The following industry supplement focuses on comment areas that are unique to registrants in the mining and metals industry. The supplement should be read in conjunction with the topics in the main section that also may contain relevant information to mining and metals registrants.

In its comments, the SEC staff may request additional information about a topic and compliance with SEC rules or accounting literature. However, the SEC staff comments are based on the registrant’s facts and circumstances, including judgments about materiality. This supplement can help companies identify the SEC staff’s areas of focus, but registrants should also consider significance to investors when including disclosure in their filings.
Summary of issues noted
The SEC staff may ask registrants to provide supplemental information for proven and probable reserves.

Analysis of current issues
Under paragraph (c) of Industry Guide 7 and Exchange Act Rule 12b-4, the SEC staff may ask for supplemental information for review by an SEC staff engineer. The SEC staff may ask registrants to provide the technical report that establishes the legal, technical and economic feasibility of the mineralization designated as reserves, including:

- Acreage breakdown by owned, leased or other
- Maps showing property, mine permit and reserve boundaries and geology, including recent and historic production areas
- Drill-hole maps showing drill intercepts
- Representative geologic cross-sections and drill logs
- Description and examples of cut-off calculation procedures
- Cutoff grades used for each category of reserves and resources
- Justifications for the drill hole spacing used at various classification levels
- General cross-sections that indicate the relationship between coal seams, geology and topography
- A detailed description of procedures and specific criteria used for estimating reserves
- An indication of how many years are left in the longest-term mining plan for each reserve area
- Site specific economic justification for the criteria used to estimate reserves
- Mining plans or feasibility studies, including production schedules, cost estimates and cash flow projections
- Third-party reviews of reserves that were developed by the entity within the last three years

After its review of the technical report, the SEC staff may question the pricing used in reserve estimates and compare it with MD&A disclosures and other public information for consistency.

Example SEC staff comment: Reserve pricing
Please clarify the mineral pricing used in the determination of your mineral reserves. In this regard we note your disclosure of $1,300 per ounce in your MD&A and $1,500 per ounce in your technical report.

Reserves
In this supplement, we analyze trends in SEC staff comment letters related to the oil and gas industry. The following table summarizes the topics the SEC staff focused on most often in comment letters sent to registrants in the oil and gas industry. Many of these topics are frequent areas of comment in letters received by registrants in other industries and are covered in the rest of this publication.

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<td>Acquisitions and business combinations</td>
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<td>Non-GAAP financial measures</td>
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* Based on comment letter topics assigned by research firm Audit Analytics for SEC comment letters issued to registrants related to Forms 10-K

The following industry supplement focuses on comment areas that are unique to registrants in the oil and gas industry. The supplement should be read in conjunction with the topics in the main section that also may contain relevant information to registrants in the oil and gas industry.

In its comments, the SEC staff may request additional information about a topic and compliance with SEC rules or accounting literature. However, the SEC staff comments are based on the registrant’s facts and circumstances, including judgments about materiality. This supplement can help companies identify the SEC staff’s areas of focus, but registrants should also consider significance to investors when including disclosure in their filings.
**Reserves**

**Summary of issues noted**
Registrants are required to disclose significant information about their oil and gas reserves under ASC 932-235 and Regulations S-X and S-K. In addition to the areas discussed below, the SEC staff continues to check consistency between a registrant’s reserve disclosures in the supplemental information accompanying its financial statements and:

- Information in MD&A
- Prior filings (e.g., the prior-year annual report)
- Other publicly available information (e.g., website or earnings calls)
- Market data (e.g., market prices)

The SEC staff also may request additional information to support reserve amounts, including well information, income forecasts, engineering reports, maps and other documentation.

**Analysis of current issues**

**Final investment decision**
To recognize proved undeveloped reserves (PUDs), a registrant must have made a final investment decision to develop an oil and gas property within five years of initial recognition, with limited exceptions. In order to meet this criterion, the registrant must be able to demonstrate, with reasonable certainty, that it will execute the development plan within the required five-year period. If the registrant subsequently changes its development plan, the SEC staff may question whether the registrant had reached a final investment decision.

The SEC staff may request historical information, such as rollforwards of PUD properties, to evaluate how well the registrant executed its drilling plans for specific properties. Citing a significant change in prices may not be sufficient to explain changes in a registrant’s final investment decision, especially if management changes drilling plans from time to time. The SEC staff may question whether the registrant identified the appropriate point in its assessment process to recognize PUDs.

If planned drilling has not occurred, the staff may challenge whether PUD recognition is appropriate, either retrospectively or prospectively. The staff may ask whether past PUD recognition was in error for properties that were not developed within five years or were subject to multiple changes in planned drilling. Alternatively, the staff may ask whether the failure to develop PUD properties in accordance with original plans is an indicator that management should evaluate whether ongoing PUD recognition is appropriate.
Appendix A: Industry supplements

Example SEC staff comment: Final investment decision

The definitions provided in paragraphs 22 and 31 of Rule 4-10(a) of Regulation S-X indicate that it is only appropriate to claim proved undeveloped reserves if it is reasonably certain that the project to develop the reserves will commence within five years, unless specific circumstances justify a longer time. Compliance and Disclosure Interpretation 131.04, issued October 26, 2009 and updated May 16, 2013, further clarifies that the mere intent to develop does not constitute "adoption" of a development plan and therefore would not, in and of itself, justify recognition of reserves. Please tell us the extent to which there are any proved undeveloped reserves as of year-end which do not have an adopted development plan and final investment decision.

Given the definitions and interpretations applicable to proved undeveloped reserves, and that you have not developed your reserves according to the plans underlying your disclosed reserve estimates, we believe you should revise your reported reserve volumes and the internal controls used in your reserve estimation process to limit disclosed proved undeveloped reserve volumes to those quantities which are reasonably certain to be developed within five years of booking.

Conversion of PUDs

The SEC staff requests that registrants with a large percentage of PUDs provide additional information about the amount and percentage of PUDs that were converted to developed reserves over the past several years. When the historical conversion rates are less than 20%, the SEC staff may challenge whether the registrant will be able to execute plans to develop PUDs within the five-year guideline.

Example SEC staff comment: PUD conversion

For the three oldest “layers” in your PUD determinations as of year-end, drilling had not proceeded according to the initial drilling schedule for the significant majority of PUD locations. In view of the consistent variation between the drilling plans underlying your PUD determinations and your actual drilling activities, together with the recurring failure to develop PUD locations with 5 years of initial booking, revise your determination and presentation of PUD reserves to include only those locations for which you can demonstrate reasonable certainty and which otherwise comply with the definitions in Rule 4-10(a) of Regulation S-X. In particular, see the definitions in Rule 4-10(a) paragraphs 22, 24 and 31. Also, see Compliance and Disclosure Interpretation 131.04.
**Expiring acreage**

Item 1208(b) of Regulation S-K requires disclosures under appropriate captions in SEC filings about undeveloped acreage, both leases and concessions, including, if material, the minimum remaining terms of leases and concessions. When a registrant has a significant number of lease expirations in the near term, the SEC staff frequently asks if there are significant PUD reserves associated with those properties and whether they will be developed prior to lease expiration. In addition, the SEC staff may request that registrants disclose the costs to maintain those leases beyond expiration to support PUD classification.

**Example SEC staff comment: PUDs and expiring acreage**

You disclose that leases covering a significant portion of your gross undeveloped acreage will expire over the next three years. Please tell us the extent to which you have assigned any proved undeveloped reserves as of year-end to locations which are currently scheduled to be drilled after lease expiration. If your proved undeveloped reserves include any such locations, please expand your disclosure to explain the steps which would be necessary to extend your legal right to these leases and to address whether you would have a legal right to produce reserves from this acreage. Refer to Rule 4-10(a)(26) of Regulation S-X.

**Changes to proved reserves**

ASC 932 requires registrants to disclose (as part of their oil and gas disclosures supplementary to the financial statements) changes in the net quantities of their proved oil and gas reserves during the year with appropriate explanation of significant changes (ASC 932-235-50-5). While entities generally capture these changes in the reserve rollforwards, the SEC staff may request that registrants discuss the reasons for significant changes (e.g., revisions, extensions, discoveries, acquisitions).

**Example SEC staff comment: Changes to proved reserves**

Please expand your disclosure to include a narrative explanation for the material changes in your proved undeveloped reserves such as the change relating to the line item entry “additional PUDs added” in the table that rolls forward changes in proved reserves. Refer to Item 1203(b) of Regulation S-K. We also note the change in your gas reserves appears to be the result of two separate causal factors (e.g., extensions and discoveries relating to your drilling and revisions relating to an increase in gas pricing). We believe disclosure regarding each of the causes for material changes in your proved undeveloped reserves should be provided under Item 1203(d) of Regulation S-K. Accordingly, please expand your disclosure to provide the change in net quantities and an explanation of such changes sufficient to reconcile the overall change in your proved undeveloped reserves.
Decline in oil prices

Summary of issues noted
The SEC staff reminded oil and gas registrants at the 2014 AICPA Conference to consider the following in light of the recent decline in oil prices:

- Does the decline in prices represent a trend or uncertainty that should be discussed in MD&A?
- Should their risk factor disclosures related to commodity price volatility be enhanced?
- Has a “final investment decision” to support the recognition of PUDs been made?

The SEC staff may ask registrants to quantify the effect of pricing trends or potential future price changes on recognized reserves or impairment analyses of oil and gas properties (or ceiling tests for full cost entities) and related long-lived assets.

Analysis of current issues
Proved undeveloped reserves
Recognition of PUDs continues to be an area of interest for the SEC staff. In addition to the considerations for PUDs mentioned above, the SEC staff also may ask registrants about the effect of other information on the recognition of PUDs, such as how reductions in forecasted capital expenditures have affected management’s assessment of PUDs.

Example SEC staff comment: Oil prices and PUDs
You disclose significant reductions in rig counts and capital expenditures compared to the prior year. However, it appears that you did not remove any PUD volumes as a result of these reductions. Tell us the extent to which your disclosed PUD volumes at year end include quantities that were delayed, deferred or rescheduled as a result of planned reductions in capital spending and development activities. Additionally, tell us the pricing assumptions used in developing your PUD development schedule.

MD&A trends and uncertainties
The SEC staff may ask registrants whether the decline in oil prices (or general volatility of commodity prices) represents a trend or uncertainty that should be discussed in MD&A. When management’s plans to develop properties or expend capital resources are sensitive to price changes, or when the entity’s overall performance is affected by changes in commodity prices, management should consider whether additional disclosures in MD&A are necessary.
Example SEC staff comment: Oil prices and MD&A trends and uncertainties

We note you evaluate upstream projects using a specific commodity price, while testing those projects for resilience at a lower price. Please describe the process through which upstream projects are tested for resilience and explain how the results impacted your estimates of proved reserves. As part of your response, please tell us how recent declines in commodity prices were a factor in this testing process. In addition, tell us whether the pattern of volatility in commodity prices discussed in your filing represents a trend or uncertainty which management considers reasonably likely to have a material effect on the recoverability of your proved reserves.

Risk factors

While oil and gas registrants may have existing risk factor disclosures about commodity prices, the SEC staff may question whether these are complete, especially in light of the decline in oil prices. The SEC staff may request that registrants provide additional quantitative disclosures about the potential effect of pricing scenarios on recognized reserves.

In addition to their potential effects on reserve quantities and revenues or costs from commodity sales or purchases, changes in commodity prices may also create risks of impairment of long-lived assets, investments or goodwill. The SEC staff may ask a registrant whether its risk disclosures have addressed all of the material risks from the decline in oil prices.

Example SEC staff comment: Commodity price uncertainty and risk factors

Your risk factor disclosures indicate that continued lower prices for oil and natural gas could have an impact on your liquidity, financial condition and results of operations. Separately, you disclose reductions in your development activities and capital expenditures. Finally, a recent earnings call described plans you have developed under different pricing scenarios and the potential impacts of different prices.

Revise your risk factor disclosure to provide additional language about the risks from the uncertainty associated with recent changes in commodity prices, including quantitative disclosure regarding your reserve quantities reflecting potential scenarios deemed reasonably likely to occur by management. Your revised disclosure should also address the possibility of impairment of your oil and gas properties if lower commodity prices continue.
Real estate supplement

In this supplement, we analyze trends in SEC staff comment letters related to the real estate industry. The following table summarizes the topics the SEC staff focused on most often in comment letters sent to registrants in the real estate industry. Many of these topics are frequent areas of comment in letters received by registrants in other industries and are covered in the rest of this publication.

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<thead>
<tr>
<th>Comment area</th>
<th>Comment rank for the 12 months ended 30 June*</th>
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<td>Fair value measurements***</td>
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<tr>
<td>Non-GAAP financial measures</td>
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<td>Consolidation</td>
<td>3</td>
</tr>
<tr>
<td>Management’s discussion and analysis</td>
<td>4</td>
</tr>
<tr>
<td>Leases</td>
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</tr>
</tbody>
</table>

* Based on comment letter topics assigned by research firm Audit Analytics for SEC comment letters issued to registrants related to Forms 10-K
** This topic wasn’t in the top 10 comment areas in 2014.
*** This category includes SEC staff comments on fair value measurements under ASC 820 as well as fair value estimates, such as those related to revenue recognition, stock compensation and goodwill impairment analyses. Individual SEC staff comments may be associated with more than one comment area in this chart.

The following industry supplement focuses on comment areas that are unique to registrants in the real estate industry. The supplement should be read in conjunction with the topics in the main section that also may contain relevant information to registrants in the real estate industry.

In its comments, the SEC staff may request additional information about a topic and compliance with SEC rules or accounting literature. However, the SEC staff comments are based on the registrant’s facts and circumstances, including judgments about materiality. This supplement can help companies identify the SEC staff’s areas of focus, but registrants should also consider significance to investors when including disclosure in their filings.
Summary of issues noted
The SEC staff may request additional information from a registrant about how it determined whether an acquired property does or does not meet the definition of a “business.”

Analysis of current issues
The definition of a “business” in ASC 805 is broad and requires the exercise of professional judgment. Careful evaluation by management is required in determining whether the acquired set of assets and activities constitutes a business. This determination is critical because the accounting for a business combination differs from that of an asset acquisition. For example, in an asset acquisition, qualifying transaction costs would be capitalized, while in a business combination those same costs would be expensed when incurred.

Under ASC 805, a business generally will consist of the following three elements: (1) inputs, (2) processes applied to those inputs and (3) outputs that are used to generate revenues. However, ASC 805 emphasizes that to be considered a business, a set of activities and assets is required to have only the first two of those three elements (i.e., inputs and processes), which together are or will be used to create outputs. Further, the acquired set of assets and activities must only be capable of being conducted and managed in order to produce outputs from the viewpoint of a market participant.

The SEC staff comments have focused on obtaining an understanding of registrants’ evaluations of whether acquired properties are or are not a business.

Example SEC staff comment: Evaluation of business combination vs. asset acquisition
Please clarify whether you plan to account for the transaction as a business combination or asset purchase. Your response should address the basis for your conclusion and cite the relevant facts, circumstances, and accounting literature relied upon.

The FASB recently proposed changes to ASC 805 that would clarify the definition of a business. If adopted, this guidance may result in registrants reaching different conclusions than they do today about whether acquired real estate properties are accounted for as business combinations or asset acquisitions. Final guidance has not been adopted and an effective date has not been discussed by the FASB.

EY resources
Financial reporting developments, Business combinations (SCORE No. BB1616), December 2014
Below-market operating leases acquired in a business combination

**Summary of issues noted**

When properties are acquired in a business combination, the SEC staff may request information about acquired assets and liabilities recognized related to operating leases. In particular, the SEC staff may ask registrants to provide additional information about the consideration of below-market lease renewal provisions when estimating the fair value of in-place leases and amortization periods.

**Analysis of current issues**

In a business combination that includes assets subject to operating leases, such as real estate with in-place leases, an assessment is required to determine whether the underlying operating leases have in-place value, as well as provisions that are favorable or unfavorable, given market conditions that existed on the date of the acquisition and the terms and conditions of the existing leases. The fair value of the underlying property and any asset or liability related to the lease contracts are recognized and measured separately. The fair value of the in-place lease should consider all provisions of the lease (e.g., term, purchase options, renewal options, termination penalties) and should be estimated in accordance with ASC 820.

The SEC staff asks for additional information about how management considers all provisions of the lease when estimating the fair value of in-place leases. As it relates to below-market leases, the SEC staff may ask registrants to explain how management assesses the likelihood of a tenant exercising its below-market renewal option when determining the fair value and related amortization periods. When making this assessment, management may consider the period remaining on the current lease term, the length of the renewal option term and the pricing of base and renewal terms in comparison to current market rates.

**Example SEC staff comment: Below-market operating leases**

Please tell us how you considered any fixed rate renewal options in the calculation of the fair value of the below market lease intangibles and the period over which your below market lease intangibles are amortized. Your response should also discuss how you determine the likelihood that a lessee will execute a below-market lease renewal, and how you consider the likelihood, if at all, in determining the amortization period.

**EY resources**

*Financial reporting developments, Lease accounting* (SCORE No. BB1793), August 2015
Summary of issues noted
The SEC staff frequently issues comments to registrants regarding funds from operations (FFO) and other non-GAAP financial measures. The SEC staff often asks that registrants describe why management considers FFO and other non-GAAP financial measures to be useful to investors. The SEC staff also may ask registrants to reconcile FFO and other non-GAAP measures to the most directly comparable GAAP financial measure and to modify line item captions within the calculation of FFO or a non-GAAP financial measure to improve the transparency of the corresponding amount presented (e.g., more clearly distinguish to which class of equity holders a non-GAAP measure is attributable).

Analysis of current issues
The SEC staff’s interpretive guidance indicates that management should clearly identify which performance indicators are considered to be useful to investors. For example, FFO, a measure defined by the National Association of Real Estate Investment Trusts (NAREIT), is a widely used non-GAAP supplemental measure of the financial performance of a real estate investment trust (REIT). The market closely follows REIT FFO expectations, and investors and analysts view FFO as a key industry performance indicator.

Real estate companies may provide supplemental and/or modified calculations of FFO, such as “adjusted” FFO (AFFO), “modified” FFO (MFFO) and “core” FFO (CFFO). While their titles may appear to be similar, the methods used in calculating these measures may vary significantly among registrants. In some circumstances, registrants have developed modified calculations of FFO that use entity-specific adjustments that management believes are uniquely important to its investors (e.g., “FFO, as defined by Company X”).

The SEC staff frequently asks management to provide additional disclosure of the usefulness of these measures, along with detailed discussion of the importance of individually significant adjustments. Registrants have also been asked to change the titles of these measures and/or enhance their discussion to clarify whether or not their measures are calculated in accordance with the NAREIT definition of FFO. The SEC staff may request compliance with other disclosure requirements, including a reconciliation to the most directly comparable GAAP financial measure.

Example SEC staff comment: Funds from Operations – usefulness
We note you have disclosed a performance measure referred to as “adjusted funds from operations.” Please provide us with a detailed analysis of why this measure is useful to investors. Where appropriate, please address the usefulness of each significant adjustment. In addition, please revise your reconciliation to reconcile AFFO to the most directly comparable GAAP financial measure.

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The SEC staff also has focused recently on improving the transparency of line item captions used when presenting calculations of FFO. Registrants that have noncontrolling interest holders or multiple classes of equity holders have frequently been asked to modify line item captions to more clearly distinguish to which class of equity holders a non-GAAP measure is attributable (e.g., “FFO attributable to Company Z,” “FFO attributable to common shareholders,” “FFO attributable to unitholders”).

Example SEC staff comment: Funds from Operations – terminology

We note that you reconcile Funds from Operations (FFO) to Net income attributable to common stockholders and it appears FFO represents FFO attributable to common stockholders. In future filings please revise the label of this non-GAAP measure to indicate that it is FFO attributable to common shareholders or tell us why this is not necessary.

The SEC staff also has asked registrants to increase transparency into individual adjustments that are included within FFO calculations by enhancing line item captions and descriptions in the footnotes to the table to better describe the nature and relevance of the adjustments.

Registrants that present other non-GAAP measures (e.g., “adjusted EBITDA,” “same-store operating income”) are also frequently asked to describe the usefulness of the measure to investors and reconcile the amount to the most directly comparable GAAP financial measure. Further discussion about SEC comments related to non-GAAP measures can be found in the SEC reporting issues section of this publication.

Resources

2014 SEC annual reports, Form 10-K (SCORE No. CC0399), December 2014
**Capital expenditures**

_Summary of issues noted_

The SEC staff may request enhanced disclosures about registrants’ cost capitalization policies in the MD&A discussion of critical accounting estimates. The SEC staff also may ask registrants to provide additional disclosures about the nature of capital expenditures.

_Analysis of current issues_

Because applying the Real Estate Project Costs subsection of ASC 970 requires significant judgment and there is diversity in practice, the SEC staff is focused on transparent disclosure in this area.

In particular, the SEC staff requests that registrants disclose:

- The types of soft costs that they capitalize, particularly indirect costs
- The methodology they used to allocate indirect costs, as well as the amount of indirect personnel and administrative costs capitalized in each year presented
- The amount of payroll costs and other overhead costs capitalized
- The capitalization period, including when capitalization begins and ends

The SEC staff also focuses on whether capital expenditure disclosures (on the face of the statement of cash flows or in MD&A) provide sufficient transparency regarding the nature of capital expenditures. The SEC staff requests that MD&A disclose and discuss separately capital expenditures related to acquisitions, new developments, redevelopments and improvements to existing properties. In addition, the total amount of capital expenditures disclosed should reconcile to the amount presented on the face of the statement of cash flows.

_Example SEC staff comment: Capital expenditures_

Please tell us and expand your disclosure in MD&A to include additional analysis of your capital expenditures breaking them down between new development, redevelopment/renovations, and other capital expenditures (i.e. capitalized interest, capitalized payroll, etc.) by year. In addition, please provide a narrative discussion of fluctuations from year to year and expectations for the future. The total of these capitalized expenditures should reconcile to the capitalized expenditures included in cash flows from investing activities within the consolidated statement of cash flows.
**Relationship of market to expiring rents**

**Summary of issues noted**

To help users understand current and future performance, the SEC staff continues to ask for enhanced disclosure in MD&A from registrants about how rental rates for expiring leases compare with the current market.

**Analysis of current issues**

The difference between contractual rental rates and market rates is known as “rental spread.” The disclosure of registrants' expected rental spreads allows users to more accurately project changes to future revenues resulting from renewal or replacement of expiring leases. This insight is particularly useful if a registrant has significant leases expiring in the next 12 months.

The SEC staff also may request enhanced disclosure that summarizes the volume of leasing activity (e.g., number of executed leases, square footage leased, rental rate per square foot) during the periods presented, the rental spread between expiring leases and current market rates for comparable leases, and costs incurred to secure new or renewed leases (e.g., leasing commissions, tenant allowances).

**Example SEC staff comment: Rental spread and leasing activity**

In future periodic filings, to the extent you have material lease expirations in the next year, please include discussion of the relationship of rents on expiring leases to market rents. In addition, please expand your disclosure of your leasing activities for the most recent period, including a discussion of the volume of new or renewed leases, average rents or yields on new and renewed leases, the relationship between new rents and old rents on re-leased space and, where applicable, average tenant improvement costs, leasing commissions and tenant concessions.
Retail and consumer products supplement

In this supplement, we analyze trends in SEC staff comment letters related to the retail and consumer products industry. The following table summarizes the topics the SEC staff focused on most often in comment letters sent to retail and consumer products registrants. Many of these topics are frequent areas of comment in letters received by registrants in other industries and are covered in the rest of this publication.

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<td>Segment reporting</td>
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<td>Revenue recognition</td>
<td>3</td>
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<tr>
<td>Signatures, exhibits and agreements</td>
<td>4</td>
</tr>
<tr>
<td>Income taxes</td>
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</table>

* Based on comment letter topics assigned by research firm Audit Analytics for SEC comment letters issued to registrants related to Forms 10-K

The following industry supplement focuses on comment areas that are unique to registrants in the retail and consumer products industry. The supplement should be read in conjunction with the topics in the main section that also may contain relevant information to retail and consumer products registrants.

In its comments, the SEC staff may request additional information about a topic and compliance with SEC rules or accounting literature. However, the SEC staff comments are based on the registrant’s facts and circumstances, including judgments about materiality. This supplement can help companies identify the SEC staff's areas of focus, but registrants should also consider significance to investors when including disclosure in their filings.
Accounting for and disclosure of gift card breakage

Summary of issues noted
The SEC staff may request that registrants, primarily in the retail industry, expand their financial statement disclosures related to the recognition of gift card revenue. The requested disclosures include the manner in which registrants recognize revenue related to the portion of gift cards that ultimately are not used by the customer for the purchase of goods or services (commonly referred to as breakage). The SEC staff may ask for disclosure of the amount of breakage recognized if it is material to the registrant.

Analysis of current issues
Many retailers sell gift cards that entitle the holder of the card to redeem them for goods and services during a redemption period, which may be specified or unspecified. Customers often do not redeem the full amount of gift cards, resulting in breakage. When a retailer is not statutorily required to escheat the unused amounts to a state or other taxing authority, a question often arises how it should account for breakage that is expected or that occurs.

There is no specific authoritative literature on accounting for gift card breakage. The liability associated with the gift card sold may be derecognized if it has been extinguished through payment of the obligation or by legal release from the liability (ASC 405).11

Subject to applicable laws, some retailers charge a service fee on customers’ unused gift card balances that, over time, amortizes any unused balances into income. Charging a service fee is a term and condition of the sale of the gift card that provides the retailer with a legal release from its obligation to the customer. However, many retailers do not charge service fees, or, when they do, the amount of the fee may not be sufficient to fully amortize unused gift card balances.

Applying the guidance in ASC 405 could result in the indefinite deferral of unused gift card balances that do not otherwise have to be escheated to a state or other taxing authority. However, the SEC staff generally does not object to derecognizing the liability by analogy to ASC 450 when a retailer has sufficient company-specific customer experience to indicate when the chance of a customer requiring performance is remote, and the amount of breakage can be objectively and reliably estimated using company-specific historical evidence.

Methods to account for breakage
The lack of authoritative guidance has led to diversity in practice in accounting for breakage. Most retailers use one of the following methods:

• Breakage is not estimated and recognized into income and therefore is carried on the balance sheet as a liability (i.e., deferred revenue) indefinitely.

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11 FASB has proposed guidance to address the extinguishment of liabilities related to certain gift cards. The proposed guidance, which was developed by the EITF, would be consistent with the breakage guidance in ASC 606 (the new revenue recognition standard).
Breakage is estimated and recognized into income as part of the normal accounting processes performed each reporting period, taking into account company-specific historical evidence of redemption rates. Breakage is estimated and recognized in one of the following ways:

- Under the “redemption recognition” method, breakage is estimated and recognized as gift cards are used for the purchase of goods or services.
- Under the “delayed recognition” method, breakage is estimated and recognized when it is apparent, based on an aging of gift card balances, that the likelihood of redemption of the outstanding gift card balances is remote.

The SEC staff has accepted these two methods, but does not believe it is appropriate to estimate and recognize breakage immediately at the point of gift card issuance.

**Income statement presentation**

Breakage, once recognized, generally should be classified as revenue when the recognition method is tied to the delivery of goods or services. Accordingly, retailers estimating and recognizing breakage into income using either the redemption recognition method or delayed recognition method generally may classify breakage as revenue. When a retailer charges a service fee on customers’ unused gift card balances, registrants often classify the amounts recognized as other income because recognition is not tied to the delivery of goods or services. If breakage is recognized as a reduction of an expense line item (e.g., cost of sales or selling, general and administrative expense), the SEC staff often asks registrants why this presentation is appropriate.

**Disclosures**

The SEC staff commonly asks registrants that estimate and recognize breakage to disclose the following in the financial statements:

- The method used to estimate and recognize breakage
- The key assumptions used to establish the estimate
- The income statement classification (revenue, gain or other income) of amounts recognized
- The balance sheet classification of deferred revenue related to the gift card liability

If the amount of breakage recognized is material to the results of operations, registrants should consider disclosing the amount of breakage recognized. They also should consider whether the estimates used to determine breakage should be discussed as a critical accounting estimate in MD&A.
### Example SEC staff comment: Breakage

We note your gift card breakage is recognized as a reduction of merchandise, buying and occupancy costs. Please clarify why it is appropriate to record the breakage as a reduction of merchandise, buying and occupancy costs. It appears your classification of breakage is not consistent with the definition of costs and expenses applicable to sales and revenues pursuant to Rule 5-03(b)(2) of Regulation S-X. In addition, provide us a draft disclosure to be included in future filings that explains how you determine when the likelihood of redemption becomes remote and tell us the amounts of breakage for the periods presented. To the extent the breakage amounts are material, disclose the amounts of breakage in future filings.
Effect of online sales on same-store metrics

Summary of issues noted
The SEC staff requests that registrants in the retail and consumer products industry quantify the effects of online sales on key performance metrics such as same-store sales. When online sales are material or result in a material change to the same-store sales metrics, the SEC staff may ask retailers to provide more information about the e-commerce component of same-store sales.

Analysis of current issues
Same-store sales is a key performance metric used by retailers. Because the definition of this metric varies, the SEC staff asks retailers to disclose how they define it and, more specifically, whether their same-store sales metric includes or excludes sales from e-commerce.

Many retailers have invested in e-commerce platforms as a distribution channel. As such channels continue to grow and become significant, the SEC staff requests that the registrant disclose information about the effect of e-commerce on its business. When online sales are material, the SEC staff expects the registrant to discuss online sales in MD&A and the related effects on its key performance metrics. If online sales are included in the registrant’s same-store sales metric, the SEC staff believes that disaggregating sales from e-commerce provides more transparent disclosure about changes in same-store sales.

Example SEC staff comment: Comparable-store sales
We note your online sales are included within your same store sales calculation. Tell us your basis for inclusion of online sales in your same store sales calculation and explain to us what consideration you gave to also disclosing same store sales excluding online sales. In addition, please expand your disclosure in future filings to quantify how online sales impacted your comparable sales. Otherwise, to the extent online sales did not have a meaningful impact to your comparable sales metric; please disclose that fact in your filings.

EY resources
2014 SEC annual reports, Form 10-K (SCORE No. CC0399), December 2014
In this supplement, we analyze trends in SEC staff comment letters related to the technology industry. The following table summarizes the topics the SEC staff focused on most often in comment letters sent to registrants in the technology industry. Many of these topics are frequent areas of comment in letters received by registrants in other industries and are covered in the rest of this publication.

<table>
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<tr>
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<td>Revenue recognition</td>
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<td>2</td>
</tr>
<tr>
<td>Fair value measurements**</td>
<td>3</td>
<td>5</td>
</tr>
<tr>
<td>Non-GAAP financial measures</td>
<td>4</td>
<td>6</td>
</tr>
<tr>
<td>Intangible assets and goodwill</td>
<td>5</td>
<td>8</td>
</tr>
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</table>

* Based on comment letter topics assigned by research firm Audit Analytics for SEC comment letters issued to registrants related to Forms 10-K

** This category includes SEC staff comments on fair value measurements under ASC 820 as well as fair value estimates, such as those related to revenue recognition, stock compensation and goodwill impairment analyses. Individual SEC staff comments may be associated with more than one comment area in this chart.

The following industry supplement focuses on up-front fees received at the outset of a cloud computing arrangement, which is an area that registrants in the technology industry commonly receive comments. The supplement should be read in conjunction with the topics in the main section that also may contain relevant information to registrants in the technology industry.

In its comments, the SEC staff may request additional information about a topic and compliance with SEC rules or accounting literature. However, the SEC staff comments are based on the registrant’s facts and circumstances, including judgments about materiality. This supplement can help companies identify the SEC staff’s areas of focus, but registrants should also consider significance to investors when including disclosure in their filings.
Summary of issues noted
The SEC staff often questions the accounting for up-front fees received by companies in the technology industry. Such fees may relate to set-up or other activities that do not represent the culmination of an earnings process or may relate to substantive deliverables (e.g., implementation, training) provided at the outset of a cloud computing arrangement. The SEC staff commonly asks registrants whether standalone value exists for the registrant’s activities performed at the outset of an arrangement and to provide the basis for the period over which the up-front fees are recognized as revenue.

Analysis of current issues
Companies in the technology industry often receive up-front fees at the outset of a cloud computing arrangement. Such fees may relate to activation or other set-up activities, data migration, training services or implementation services. Registrants need to carefully evaluate whether such activities represent deliverables in the arrangement and, if so, whether the deliverables are separable from the cloud services. When evaluating separability, registrants are required to consider whether standalone value exists for the deliverable. Standalone value exists if either the vendor or any other vendor can sell the item on a standalone basis. Determining whether the up-front activities are deliverables in the arrangement and whether such deliverables are separable requires significant judgment. The SEC staff often asks registrants to describe how they have considered the separation criteria in ASC 605-25-25-5.

Example SEC staff comment: Standalone value
We note in your disclosure that set-up fees do not have standalone value. Please explain your basis for concluding that these fees do not have standalone value and tell us how you considered ASC 605-25-25-5(a).

The SEC staff also asks registrants to explain how they’ve considered the guidance in SAB Topic 13A.3.f when determining the period over which up-front fees are recognized. Unless the payment of an up-front fee relates to a deliverable that is separable from the cloud service, deferral of revenue for the up-front fee is required. If up-front fees are deferred, registrants must determine the appropriate period over which to recognize the fees as revenue.

SAB Topic 13A.3.f states that, unless the fees relate to discrete earnings events, the recognition period for the up-front fee should extend beyond the contractual period if renewals or additional contracts are expected that would extend the life of the customer relationship beyond the initial term. Registrants should evaluate individual contracts to determine whether the up-front fees relate to discrete earnings events. This assessment requires significant judgment. When activities associated with up-front fees are determined to not have standalone value, the SEC staff often asks registrants to explain why the up-front fee is recognized over the contract term rather than over the estimated life of the customer relationship.
Example SEC staff comment: Period of recognition

Please explain your basis for recognizing set-up fees over the term of the associated contract rather than the expected customer life. In this respect, we note that you do not have standalone value for these services. We refer you to the guidance in footnote 39 of SAB Topic 13A.3.f.

When assessing the period over which up-front fees (that do not relate to discrete earnings events) are recognized as revenue, registrants should carefully evaluate whether the customer may continue to benefit beyond the initial contact term (e.g., subsequent renewals are priced at a bargain to the initial up-front fee).

EY resources

Technical Line, *Effects of the new multiple-element revenue guidance on cloud computing vendors* (SCORE No. BB1946), June 2010
The following tables summarize the topics the SEC staff focused on most often in comment letters sent to registrants in several other industries. Many of these topics are frequent areas of comment in letters received by registrants that are covered in the rest of this publication.

**Aerospace and defense industry**

<table>
<thead>
<tr>
<th>Comment area</th>
<th>2015</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management’s discussion and analysis</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>State sponsors of terrorism</td>
<td>2**</td>
<td></td>
</tr>
<tr>
<td>Acquisitions and business combinations</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>Revenue recognition</td>
<td>4</td>
<td>2</td>
</tr>
<tr>
<td>Non-GAAP financial measures</td>
<td>5**</td>
<td></td>
</tr>
</tbody>
</table>

**Automotive industry**

<table>
<thead>
<tr>
<th>Comment area</th>
<th>2015</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Segment reporting</td>
<td>1</td>
<td>**</td>
</tr>
<tr>
<td>Management’s discussion and analysis</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Inventory or cost of sales</td>
<td>3</td>
<td>**</td>
</tr>
<tr>
<td>Accrued liabilities, including restructuring and warranty accruals</td>
<td>4</td>
<td>6</td>
</tr>
<tr>
<td>Non-GAAP financial measures</td>
<td>5</td>
<td>3</td>
</tr>
</tbody>
</table>

**Media and entertainment industry**

<table>
<thead>
<tr>
<th>Comment area</th>
<th>2015</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management’s discussion and analysis</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Revenue recognition</td>
<td>2</td>
<td>5</td>
</tr>
<tr>
<td>Intangible assets and goodwill</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>Segment reporting</td>
<td>4</td>
<td>3</td>
</tr>
<tr>
<td>Acquisitions and business combinations</td>
<td>5</td>
<td>4</td>
</tr>
</tbody>
</table>
### Power and utilities industry

<table>
<thead>
<tr>
<th>Comment area</th>
<th>2015</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management’s discussion and analysis</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Regulatory assets and liabilities</td>
<td>2</td>
<td>4</td>
</tr>
<tr>
<td>Revenue recognition</td>
<td>3</td>
<td>**</td>
</tr>
<tr>
<td>Income taxes</td>
<td>4</td>
<td>7</td>
</tr>
<tr>
<td>Fair value measurements***</td>
<td>5</td>
<td>2</td>
</tr>
</tbody>
</table>

**This topic wasn’t in the top 10 comment areas in 2014.

***This category includes SEC staff comments on fair value measurements under ASC 820 as well as fair value estimates, such as those related to revenue recognition, stock compensation and goodwill impairment analyses. Individual SEC staff comments may be associated with more than one comment area in this chart.

### Telecommunications industry

<table>
<thead>
<tr>
<th>Comment area</th>
<th>2015</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management’s discussion and analysis</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Revenue recognition</td>
<td>2</td>
<td>9</td>
</tr>
<tr>
<td>Expense classification (SG&amp;A, cost of sales)</td>
<td>3</td>
<td>**</td>
</tr>
<tr>
<td>Non-GAAP financial measures</td>
<td>4</td>
<td>**</td>
</tr>
<tr>
<td>Executive compensation disclosures</td>
<td>5</td>
<td>4</td>
</tr>
</tbody>
</table>

* Based on comment letter topics assigned by research firm Audit Analytics for SEC comment letters issued to registrants related to Forms 10-K
This IPO supplement should be read in conjunction with the topics in the main section and other appendices that may be relevant to a company’s IPO registration statement filing.

The following chart summarizes the top 10 most frequent comment areas related to registration statements on Form S-1 in the current and previous years:

<table>
<thead>
<tr>
<th>Comment area</th>
<th>Ranking 12 months ended 30 June</th>
<th>Comments as % of total registrants that received comment letters*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management's discussion and analysis</td>
<td>1</td>
<td>62%</td>
</tr>
<tr>
<td>Signatures, exhibits and agreements</td>
<td>2</td>
<td>48%</td>
</tr>
<tr>
<td>Risk factors</td>
<td>3</td>
<td>50%</td>
</tr>
<tr>
<td>Use of proceeds and dilution disclosures</td>
<td>4</td>
<td>32%</td>
</tr>
<tr>
<td>Related party disclosures</td>
<td>5</td>
<td>30%</td>
</tr>
<tr>
<td>Pro forma financial information</td>
<td>6</td>
<td>25%</td>
</tr>
<tr>
<td>Identification of directors and officers</td>
<td>7</td>
<td>23%</td>
</tr>
<tr>
<td>Emerging growth companies</td>
<td>8</td>
<td>28%</td>
</tr>
<tr>
<td>Debt, warrants &amp; equity security issues</td>
<td>9</td>
<td>19%</td>
</tr>
<tr>
<td>Executive compensation disclosures</td>
<td>10</td>
<td>23%</td>
</tr>
</tbody>
</table>

* Based on comment letter topic taxonomy, excluding topics related to the terms of the offering or general updating of prospectus information, according to research firm Audit Analytics for SEC comment letters issued to companies on their Form S-1 registration statements from 1 July 2013 through 30 June 2015

This supplement does not repeat SEC staff comments or trends related to several of these comment areas that are discussed elsewhere in the publication. It discusses specific matters and topics that the SEC staff may raise in comments related to IPO registration statements, including matters related to stock compensation, pro forma financial information, disclosure and filing requirements of emerging growth companies, and dilution disclosures.

In its comments, the SEC staff may request additional information about the related topic and compliance with SEC rules or accounting literature. However, the SEC staff comments vary based on facts and circumstances, including judgments about materiality. This supplement can help companies identify the SEC staff’s areas of focus, but companies should also consider significance to investors when including disclosure in their filings.
Summary of issues noted
The SEC staff continues to ask registrants for information to support their valuations underlying share-based payment awards, especially when the fair value of the company’s pre-IPO common stock is significantly less than the expected IPO price.

Analysis of current issues
One of the key accounting issues in many IPO transactions is the valuation of equity securities (including stock options) issued as compensation while a company is privately held. In many cases, the estimated fair value of equity securities granted in the months before the IPO is significantly less than the IPO prices. As a result, the SEC staff may question pre-IPO fair value estimates and adequacy of the related disclosures in the financial statements and MD&A.

Example SEC staff comment: Valuation of pre-IPO equity securities

Please reconcile and explain any difference between the fair value of the underlying units recently granted by your Board of Directors and the midpoint of your estimated IPO offering range. This reconciliation should describe significant intervening events within the company and changes in assumptions as well as weighting and selection of valuation methodologies employed that explain the changes in the fair value of your common unit up to the filing of the registration statement.

The SEC’s Financial Reporting Manual (FRM) states that companies should disclose all of the following information on share-based compensation in the financial statements included in an IPO filing:

- The methods used to determine the fair value of the company's shares and the material assumptions used in determining the fair value
- The extent to which such estimates are considered highly complex and subjective
- That such estimates will not be necessary for new awards once the shares begin trading

Companies should discuss the material assumptions used and describe the methodology and judgments used, highlighting that they may be complex and subjective.

However, the FRM states that, while the SEC staff may issue comments to help it understand unusual valuations, the staff will not expect expanded disclosure in MD&A related to the underlying events and business developments that affected such valuations.

The SEC staff expects registrants to support judgments and estimates about the fair value of their securities anytime they grant significant share-based payments. The AICPA's Accounting and Valuation Guide, Valuation of Privately-Held-Company Equity Securities Issued as Compensation (the Guide), provides a framework and best practices for valuing private company securities. The SEC staff expects privately held companies contemplating IPOs to apply the Guide’s valuation guidance when granting share-based payments.
The Guide recommends that private companies obtain contemporaneous valuations from independent valuation specialists to determine the fair value of securities issued as compensation. The Guide asserts that a contemporaneous valuation by an independent party is more objective and provides more persuasive evidence of fair value than a retrospective valuation or one that is performed by a related party (e.g., a director, officer, investor, employee or the investment firm underwriting the IPO). The SEC staff frequently asks about estimates of the fair value of share-based payments issued before the IPO, even if a contemporaneous independent valuation has been obtained. Accordingly, a well-documented timeline of significant intervening events, with contemporaneous valuations supporting grants throughout the 12-month period before an IPO, can help a registrant to support its judgments and assumptions.

The SEC staff also expects private companies to consider other relevant data points when valuing equity securities. For example, private companies may sell equity securities to third parties, or employees and other stockholders may sell shares in secondary markets. The SEC staff expects registrants to provide an analysis of the weightings assigned to any stock sale transactions on or before the valuation date.

**EY resources**

- Financial reporting developments, Share-based payment (SCORE No. BB1172), July 2015
Summary of issues noted

Certain circumstances related to IPOs may warrant the presentation of pro forma financial information on the face of the financial statements included in the IPO registration statement. In these situations, the SEC staff has asked registrants about how they have considered the need to present pro forma information in light of the SEC staff’s guidance.

Analysis of current issues

When IPO proceeds are used to pay dividends to the issuer’s prior owners, promoters and/or parents, SAB Topic 1-B.3 requires registrants to evaluate whether they are required to present pro forma earnings per share (EPS) or a pro forma balance sheet on the face of the financial statements included in the IPO filing. Registrants should provide a pro forma balance sheet alongside the historical financial statements to reflect an accrual, with an offsetting amount to retained earnings if the dividends are not reflected in the latest balance sheet. In addition, the SAB Topic requires pro forma EPS if dividends paid at or before the closing of an IPO are greater than the earnings for the most recent year.

The SEC staff may also comment on the application of the SAB Topic when the registrant has paid dividends during the 12 months before the offering or disclosed an intent to pay dividends using IPO proceeds.

Example SEC staff comment: SAB Topic 1-B.3

We note that as part of your use of the net proceeds from this offering you intend to make a distribution to shareholders. Please explain to us what consideration you gave to providing a pro forma balance sheet alongside your latest historical balance sheet reflecting the distribution accrual (but not giving effect to the full offering proceeds) and providing pro forma earnings per share information giving effect to the number of shares whose proceeds would be necessary to pay the distribution. Reference is made to SAB Topic 1-B.3.

Registrants also may be required to present pro forma EPS or a pro forma balance sheet in connection with an IPO when there are material changes in capital structure or tax status or when IPO proceeds will be used to extinguish debt.

EY resources

Financial reporting developments, Earnings per share (SCORE No. BB1971), July 2015

Pro forma financial information, A guide for applying Article 11 of Regulation S-X (SCORE No. CC0416), September 2015
Emerging growth companies

Summary of issues noted
Since the enactment of the Jumpstart Our Business Startups Act (JOBS Act), which created a new category of issuer called an emerging growth company (EGC), in 2012, EGCs have taken advantage of the scaled disclosures in their IPO registration statements. The SEC staff may ask EGCs about their disclosures and filing requirements, including:

- Discussion of EGC status and elections made under the EGC provisions of the JOBS Act
- Submission of “test-the-waters” communications

Analysis of current issues
The SEC staff continues to ask EGCs to include additional disclosures about elections made under the EGC provisions and related risk factors. For example, if applicable, an EGC should disclose its election to opt out of any extended transition period to comply with new or revised accounting standards as if it were a privately held company (i.e., elect to follow public company effective dates) and that such election is irrevocable. Conversely, if the registrant elects to retain the option to use the extended transition period to comply with new or revised accounting standards, the SEC staff expects the registrant to include a risk factor stating that in the future its financial statements may not be comparable to companies complying with public company effective dates.

Example SEC staff comment: Emerging growth companies
Since you are an “emerging growth company,” please state your election under Section 107(b) of the JOBS Act:

- If you have elected to opt out of the extended transition period for complying with new or revised accounting standards pursuant to Section 107(b), include a statement that the election is irrevocable; or
- If you have elected to use the extended transition period for complying with new or revised accounting standards under Section 102(b)(2), provide a risk factor explaining that this election allows you to delay the adoption of new or revised accounting standards that have different effective dates for public and private companies until those standards apply to private companies. Please state in your risk factor that, as a result of this election, your financial statements may not be comparable to companies that comply with public company effective dates.

In addition, the JOBS Act permits an EGC to “test the waters” by communicating with certain institutional buyers and accredited investors before or after it files its registration statement. The SEC staff often requests EGCs to provide copies of all written testing-the-waters communications to evaluate whether the information is materially consistent with the information disclosed in the registration statement. Such materials can be submitted in hard copy rather than electronically via EDGAR, and registrants should consult with their legal counsel about how to request confidential treatment under Rule 83 for any materials submitted.

EY resources
The JOBS Act: 2015 mid-year update, An overview of implementation and an analysis of emerging growth company trends (SCORE No. CC0419), September 2015
Capsule financial information

Summary of issues noted
The SEC staff may ask companies that present preliminary results or estimates in their registration statements to provide additional context and measures in their disclosures.

Analysis of current issues
An IPO registration statement may include capsule or “recent developments” financial information (i.e., financial information such as sales for a recently completed period for which financial statements are not included). The SEC staff said at the 2014 AICPA Conference that while a discussion of preliminary results or estimates for the latest reporting period can be useful to investors, companies should provide the proper context for such a discussion so that the disclosures are not misleading.

The SEC staff may request that companies provide additional disclosures about whether the preliminary results are consistent with recent trends. In addition, if a company only presents preliminary revenue information, the staff may question whether other measures (e.g., those related to profitability) are available or necessary for investors to understand the results.

Example SEC staff comment: Capsule financial information

We note that you intend to disclose preliminary revenue and comparable store sales for the quarter ended March 31, 2015 and have the following comments:

- Please provide additional disclosure to put these measures into context for your investors such as whether these measures are consistent with the trends disclosed in MD&A, and if not, why not.

- Additionally, as revenue information alone presents an incomplete picture of your results, please disclose whether you expect profitability and other significant financial statement line items to reflect a similar trend. If this information is unknown, clearly disclose this, including the fact that your profitability trends may differ from your revenue and same store sales trends.
Summary of issues noted
The SEC staff may ask companies about their disclosures related to stock dilution under Item 506 of Regulation S-K and request more information about how they calculated the net tangible book value per share and why they included or excluded certain assets and costs.

Analysis of current issues
Item 506 of Regulation S-K requires the disclosure of the dilution, if substantial, resulting from the IPO transaction, including:

- Net tangible book value per share before and after the distribution
- The increase in net tangible book value per share attributable to the cash paid by purchasers of the shares being offered
- The amount of immediate dilution that will be absorbed by the purchasers

While SEC rules and regulations do not define net tangible book value, the staff believes this measure is intended to approximate the liquidation value. The staff generally believes that intangible asset and deferred costs should be excluded from the calculation if they cannot be sold separately from the assets of the business or if they are subject to significant uncertainty or illiquidity.

The staff often compares the dilution calculations to the historical financial statements and may question why companies included or excluded certain assets, offering expenses or noncontrolling interests from those calculations.

Example SEC staff comment: Dilution disclosures
Please show us how you calculated pro forma net tangible book value of $XX million or $X.XX per common share after the offering and net tangible book value of $X.XX per common share before the offering. Explain to us if your calculations considered goodwill and all intangible assets. In addition, it appears that the offering proceeds used to compute pro forma net tangible book value per common share after the offering were not reduced to reflect estimated offering expenses. Please revise your dilution table to give effect to the estimated expenses of the offering.
The SEC staff’s comments to foreign private issuers (FPIs) often are similar to its comments to domestic registrants. These comments involve financial reporting matters whether the FPI prepares its financial statements in accordance with US GAAP or IFRS.

Many of the topics in the main and industry supplement sections of this publication are equally relevant for FPIs and are not repeated here, such as:

- MD&A matters, including comments on critical accounting estimates, results of operations and liquidity
- Fair value measurements and accounting estimates
- Segment reporting
- Consolidations, including variable interest entities
- Income taxes, including deferred tax assets and foreign earnings
- Operating items, including revenue recognition, hedging and impairment

The following chart summarizes the top 10 most frequent comment areas in 2014 and 2015 related to annual reports on Form 20-F:

<table>
<thead>
<tr>
<th>Comment area</th>
<th>12 months ended 30 June</th>
<th>Ranking</th>
<th>Comments as % of total registrants that received comment letters*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management's discussion and analysis</td>
<td>2015: 1</td>
<td>2014: 1</td>
<td>2014 and 2015: 44%</td>
</tr>
<tr>
<td>Fair value measurements**</td>
<td>2015: 2</td>
<td>2014: 2</td>
<td>2014 and 2015: 26%</td>
</tr>
<tr>
<td>Consolidation accounting</td>
<td>2015: 3</td>
<td>2014: 5</td>
<td>2014 and 2015: 17%</td>
</tr>
<tr>
<td>State sponsors of terrorism</td>
<td>2015: 4</td>
<td>2014: 3</td>
<td>2014 and 2015: 21%</td>
</tr>
<tr>
<td>Revenue recognition</td>
<td>2015: 5</td>
<td>2014: 8</td>
<td>2014 and 2015: 14%</td>
</tr>
<tr>
<td>Oil, gas and mining reserves</td>
<td>2015: 7</td>
<td>2014: 11</td>
<td>2014 and 2015: 11%</td>
</tr>
<tr>
<td>Segment reporting</td>
<td>2015: 8</td>
<td>2014: 14</td>
<td>2014 and 2015: 11%</td>
</tr>
<tr>
<td>Fixed assets</td>
<td>2015: 9</td>
<td>2014: 4</td>
<td>2014 and 2015: 15%</td>
</tr>
<tr>
<td>Intangible assets and goodwill</td>
<td>2015: 10</td>
<td>2014: 9</td>
<td>2014 and 2015: 15%</td>
</tr>
</tbody>
</table>

* Based on comment letter topic taxonomy, excluding topics related to the terms of the offering or general updating of prospectus information, according to research firm Audit Analytics for SEC comment letters issued to companies on their annual reports on Form 20-F from 1 July 2013 through 30 June 2015.

** This category includes SEC staff comments on fair value measurements under ASC 820 as well as fair value estimates, such as those related to revenue recognition, stock compensation and goodwill impairment analyses. Individual SEC staff comments may be associated to multiple comment areas in this chart.

Below are topics and specific matters that the SEC staff may raise in comments to FPIs, some of which, such as non-GAAP financial measures and activities with countries designated as state sponsors of terrorism, are not unique to FPIs.
Summary of issues noted

The SEC staff frequently asks FPIs to provide additional information about business activities in or with countries identified by the US State Department as state sponsors of terrorism, which currently are Iran, Sudan and Syria. The SEC staff reviews different sources, including company websites (e.g., company location and contact listings) and press releases, to identify registrants with operations in these countries. If an FPI has been identified as having any business operations in or with one of those countries, the SEC staff periodically (e.g., every year or two) asks for updates on those activities.

Analysis of current issues

US securities laws do not impose a specific disclosure requirement that addresses business activities in or with a country based on its designation as a state sponsor of terrorism. However, Rule 408 of Regulation C and Exchange Act Rule 12b-20 require a registrant to disclose additional information if it is material and necessary to make its filings not misleading, given the registrant’s facts and circumstances. Because of these rules, the SEC staff frequently asks registrants to provide and, based on materiality, to disclose the following:

- The nature and extent of past, current and any anticipated operations in or with a country designated as a state sponsor of terrorism, whether through subsidiaries, affiliates, joint ventures, distributors, resellers or other direct or indirect arrangements
- Any agreements, services or other contracts registrants have had with the governments, or entities controlled by the governments, designated as state sponsors of terrorism
- Whether registrants have offices, facilities, equipment, ground services, sales agents or other employees in such countries
- Whether any of the technologies or materials provided or intended to be provided to a country designated as a state sponsor of terrorism are controlled items included in the US Department of Commerce's Commerce Control List
- Whether operations in or with state sponsors of terrorism constitute a material risk in quantitative terms by discussing revenues, assets and liabilities associated with such operations and qualitative factors that a reasonable investor would deem important in making an investment decision

In addition to these requests for information, the Iran Threat Reduction and Syria Human Rights Act of 2012 requires public companies to disclose in their annual and quarterly reports filed with the SEC whether they or their affiliates knowingly engaged in various prohibited activities involving Iran.
Non-GAAP financial measures

Example SEC staff comment: Activities with countries designated as state sponsors of terrorism

You disclose that institutional investors with policies or restrictions that prevent them from holding securities of companies that have contracts with countries identified by the US government as state sponsors of terrorism may decide not to invest in, or to divest from, your common shares. It appears from your disclosure that you may enter into contracts with individuals or entities in countries that are US-designated state sponsors of terrorism, so long as the individuals or entities are not controlled by the governments of those countries. Please clarify for us whether you anticipate entering into such contracts and, if so, describe for us the types of contracts you may enter into with such individuals or entities in countries that are US-designated state sponsors of terrorism.

Summary of issues noted

The SEC staff may challenge whether non-GAAP financial measures disclosed in filings of FPIs are required or expressly permitted by local accounting and disclosure standards. If such disclosures are required or permitted by local standards, the non-GAAP measures may be presented pursuant to a Regulation G and S-K Item 10(e) exemption without significant additional disclosure. Otherwise, the SEC staff challenges the usefulness of non-GAAP financial measures disclosed in FPI filings.

Analysis of current issues

Companies preparing their disclosures under a reporting framework other than US GAAP are often required by local rules and regulations to disclose items that the SEC otherwise considers to be non-GAAP financial measures. The SEC staff evaluates all non-GAAP items, including those expressed as percentages or per-share amounts. When an FPI presents non-GAAP items and it is unclear whether they qualify for the Regulation G and S-K Item 10(e) exemption, the SEC staff asks the registrant to address the following:

- Whether the item is required or permitted by the issuer’s reporting framework
- The literature that the company relied on to conclude that the issuer’s reporting framework either requires or permits disclosing the item
- When permitted, the economic substance behind management’s decision to disclose the item

When the non-GAAP measure is not exempt under Regulation G and S-K Item 10(e), the SEC staff asks FPIs about the presentation, its usefulness and the reconciliation of the non-GAAP measure. For further discussion, refer to the Non-GAAP financial measures discussion in the SEC reporting issues section of this publication.
**Ebola virus outbreak**

**Summary of issues noted**

The SEC staff is asking registrants with significant operations in West Africa to explain how they considered whether to include a risk factor regarding the negative effects the Ebola virus outbreak could have on their businesses.

**Analysis of current issues**

The Ebola virus epidemic is ongoing in three West African countries. The outbreak began in Guinea in December 2013 and spread to Liberia and Sierra Leone. The current Ebola virus outbreak is the most widespread in history. By the end of July 2015, over 27,000 suspected cases and 11,000 deaths were reported.

The SEC staff expects registrants with significant operations in West Africa to give consideration to whether the current Ebola virus outbreak may have a significant negative effect on their businesses in the region. When such a risk factor is identified, relevant disclosures are required by Item 503(c) of Regulation S-K.

**Example SEC staff comment: Ebola virus outbreak**

We note that a significant portion of your sales were from the Africa segment. We also note some press reports indicating that the current Ebola outbreak in West Africa could significantly affect economies in that region. Please tell us what consideration you gave to whether you should include a risk factor regarding the negative effects the Ebola virus outbreak could have on your business.

**Foreign operations with uncertainties**

**Summary of issues noted**

The SEC staff often questions registrants' disclosures of risks and uncertainties related to foreign operations, such as uncertainty regarding the status of Argentina as a highly inflationary economy and risks related to currency exchange mechanisms in Venezuela.

**Analysis of current issues**

**Argentina**

According to the IMF World Economic Outlook (WEO) report, Argentina’s estimated cumulative three-year inflation rate was 47% in 2014 and is projected to be 60% by the end of 2015.

Consumer price data from January 2014 onward reflects a new national CPI (IPCNu). Projection of the reported inflation as measured by IPCNu would be higher than projections using the previous inflation indicator.

At the May 2015 International Practices Task Force meeting, the SEC staff noted that it has not observed objectively verifiable data that would indicate the economy of Argentina is highly inflationary at 31 December 2014. However, the staff asked registrants to monitor the IPCNu inflation data and consider the level of inflation, in combination with other pertinent factors and data points, in determining whether Argentina should be considered a highly inflationary economy.
Companies with significant operations in Argentina should include relevant disclosures in the risk factors and management’s discussion and analysis (MD&A) sections of their SEC filings, as appropriate.

**Example SEC staff comment: Argentina**

We are aware Argentina recently unveiled a new inflation index which appears to indicate a higher level of inflation. Please revise your disclosure to discuss this new inflation index. Further, revise your disclosures to discuss how the new inflation index could affect your financial statements.

**Venezuela**

Due to the multiple legal exchange rates that now exist in Venezuela, repatriation restrictions and the country’s status as a highly inflationary economy, companies with exposure to Venezuela should challenge their disclosures in the notes to their financial statements and in the business, risk factors and MD&A sections of their SEC filings, as appropriate.

For further discussion about recent SEC staff comments refer to the *Foreign Currency Matters* section of this publication.

**Other foreign countries with uncertainties**

Registrants with significant operations in foreign countries facing political or economic uncertainties should consider appropriate disclosures about the effects of these uncertainties on their operating results and risk factors, as required by Items 303 and 503(c) of Regulation S-K.

Current economic developments in Greece and the sanctions against Russia are examples of uncertainties that should be closely monitored. Although we have not yet seen many SEC staff comment letters related to operations in these countries, we believe this may become a future area of focus. Registrants with significant operations in those countries should evaluate their facts and circumstances to determine whether additional disclosures are necessary.
Appendix D: SEC review process and best practices

The Division of Corporation Finance (DCF) of the SEC selectively reviews filings made under the Securities Act of 1933 and the Securities Exchange Act of 1934 to monitor and enhance compliance with disclosure and accounting requirements. In its filing reviews, DCF accountants concentrate on disclosures and accounting methods that may conflict with US GAAP or SEC rules, or that may need clarification. Other DCF staff may review other aspects of SEC filings for compliance with the federal securities laws and regulations. DCF performs its primary review responsibilities through 12 offices that each have specialized industry, accounting and disclosure expertise. DCF assigns public companies in a particular industry to one of these 12 Assistant Director Offices as shown below based upon their Standard Industrial Classification (SIC) code. Each company's office assignment is listed in EDGAR within the basic company information that precedes the company's filing history.

<table>
<thead>
<tr>
<th>Office</th>
<th>Primary industries</th>
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<tbody>
<tr>
<td>1</td>
<td>Healthcare and insurance</td>
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<tr>
<td>2</td>
<td>Consumer products</td>
</tr>
<tr>
<td>3</td>
<td>Information technologies and services</td>
</tr>
<tr>
<td>4</td>
<td>Natural resources</td>
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<tr>
<td>5</td>
<td>Transportation and leisure</td>
</tr>
<tr>
<td>6</td>
<td>Manufacturing and construction</td>
</tr>
<tr>
<td>7</td>
<td>Financial services I (smaller and mid-tier banks)</td>
</tr>
<tr>
<td>8</td>
<td>Real estate and commodities</td>
</tr>
<tr>
<td>9</td>
<td>Beverages, apparel and mining</td>
</tr>
<tr>
<td>10</td>
<td>Electronics and machinery</td>
</tr>
<tr>
<td>11</td>
<td>Telecommunications</td>
</tr>
<tr>
<td>12</td>
<td>Financial services II (large financial institutions)</td>
</tr>
</tbody>
</table>

The SEC's Office of Disclosure Standards focuses on the effectiveness of DCF's review program and the quality and consistency of comment letters.

**Required and selective review**

As required by the Sarbanes-Oxley Act of 2002, DCF staff reviews, at some level, every registrant at least once every three years, but it reviews many registrants more frequently. In addition, DCF staff generally reviews all IPOs and Form 8-K Items 4.01 and 4.02 and selectively reviews other transactional filings, such as those made in connection with business combination transactions, proxy statements or other public offerings. Effective 1 July 2015, DCF staff publicly sends “no-review” letters when it has not selected an issuer’s registration statement for review.

In many cases, DCF staff conducts a preliminary review before determining what level of further review to conduct, as discussed below. Prior to issuing comments, DCF staff considers all public information such as company websites, press releases and analyst calls in addition to the content of the filing.
The SEC staff has reviewed approximately 50% of registrants each year since 2011. The following graph summarizes the percentage of registrants reviewed in each of the last five years:

![Percent of issuers reviewed graph](source: SEC 2014 Annual Performance Report)

In addition, the SEC staff has sent the majority of its comment letters to larger public companies, as illustrated below.  

![Size of registrants receiving comment letters on Form 10-K filings](source: Audit Analytics – Comment letters issued related to Forms 10-K for the 12-month period ended 30 June 2015)

**Levels of review**

If DCF staff selects a filing for review, the extent of that review will depend on many factors. The level of review may be:

- A full cover-to-cover review in which DCF staff examines the entire filing for compliance with the applicable requirements of the federal securities laws and regulations
- A financial statement review in which DCF staff examines the financial statements and related disclosure, such as MD&A, for compliance with the applicable accounting standards and SEC disclosure requirements

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12 This graph shows the size (based on public float) of companies that received comment letters on Form 10-K filings during the 12 months ended 30 June 2015. However, the SEC staff may not send a comment letter to every registrant that it reviews.
• A targeted issue review in which DCF staff examines one or more specific items of disclosure in the filing for compliance with the applicable accounting standards or the disclosure requirements of the federal securities laws and regulations.

DCF staff may not always inform registrants of the type of review performed (such as a target review or a full review), but it will focus on what it considers necessary in the company’s circumstances. When DCF staff believes that a registrant can enhance its disclosure or improve its compliance with the applicable disclosure requirements, it makes comments in a letter to the registrant. The range of possible comments is broad and depends on the issues that arise in a particular filing review. DCF staff completes many filing reviews without issuing any comments. In those cases, the registrant will not be notified that its SEC filing was reviewed.

In addition to an initial reviewer, at least one other more senior DCF staff member typically reviews a filing and proposed comments. This second level review is intended to enhance quality and consistency across filing reviews.

**DCF staff comments**

DCF staff views the comment process as a dialogue with a registrant about its disclosures. DCF staff’s comments are in response to a registrant’s disclosures and other public information and are based on DCF staff’s understanding of that registrant’s facts and circumstances. At the time of the initial comment letter, DCF staff may be seeking additional information and may not have concluded that there is a deficiency or that additional disclosure is necessary.

In its comments, DCF staff may request that a registrant (1) provide additional supplemental information in a response letter so it can better evaluate the registrant’s disclosure, (2) amend its SEC filing to revise or supplement its disclosures or (3) provide additional or different disclosures in a future filing with the SEC.

**Best practices for registrant responses to comments**

A registrant generally responds to the SEC comment letter by sending a letter back to DCF staff. When responding to DCF staff comment letters, registrants should consider the following:

• Responses to each comment should focus on the question(s) asked by the SEC staff, and those responses should cite authoritative literature wherever possible.

• Responses should address the registrant’s unique facts and circumstances. While it may be helpful to consider response letters from other registrants as a resource, registrants should not just copy responses made by other registrants to similar comments.

• Registrants should file all response letters on EDGAR redacting any specific information for which they are seeking confidential treatment.

• If revisions are being made to a filing as a result of a comment from DCF staff, responses should indicate specifically where these revisions are being made. If additional disclosure will be included in a future filing, it may be helpful for the registrant to provide the proposed language in their response letter to avoid an additional comment once the disclosure is filed.
Companies should seek the input of all appropriate internal personnel and professional advisers (such as legal counsel and independent auditors) to ensure they have fully responded to the comment letter in a complete and accurate manner. Waiting to a later round of comments to involve the necessary resources may delay or hinder a successful resolution.

A registrant should not assume that because DCF staff has issued a comment that it disagrees with the registrant’s disclosures or accounting treatment. Providing a thorough explanation or analysis of an issue to DCF staff beyond the existing disclosure may help DCF staff better understand the accounting and disclosure, and it often will resolve the comment. To facilitate such responses, registrants should maintain contemporaneous documentation of significant accounting and disclosure decisions. Judgment applied and documented contemporaneously is more persuasive than a retrospective defense following receipt of a DCF staff comment.

Depending on the nature of the issue, DCF staff's concerns and the registrant’s response, DCF staff may issue more comments following its review of the registrant’s response. This comment and response process continues until the DCF staff and the registrant resolve all comments.

The following graph shows the number of comment letters (or rounds) that were issued by the SEC staff for reviews completed during the 12 months ended 30 June 2015:

The majority of reviews are closed after one or two comment letters, which shows that a well-organized process for responding to SEC staff comments can minimize the amount of back and forth with the SEC staff.

Comment letters from DCF staff on certain filings often request a written response within 10 business days. If a registrant needs more time to respond, it should contact the DCF staff, which is generally accommodating in granting extensions that will enhance the quality of the response letter. A registrant also may consider contacting the DCF staff if it needs additional clarification about a comment.
Closing a filing review

When a registrant has satisfactorily resolved all DCF staff’s comments on a filing, DCF staff provides the registrant with a “completion of review letter” to confirm that the SEC staff’s review is complete. To increase the transparency of the review process, after the DCF staff completes a filing review, it publicly releases its comment letters and registrant responses to those letters on the SEC’s EDGAR system no earlier than 20 business days after the review’s completion.

Reconsideration process

DCF staff and the registrant may ultimately disagree about an accounting or disclosure matter. A registrant should, in any instance it wishes, seek reconsideration of a comment by other SEC staff, including those within DCF’s Office of the Chief Accountant (DCF-OCA).

DCF staff members, at all levels, are available to discuss disclosure and financial statement presentation matters with a registrant and its legal, accounting and other advisers. A registrant may request that DCF staff reconsider a comment or reconsider a DCF staff member’s view of the registrant’s response at any point in the filing review process. DCF does not have a formal protocol for registrants to follow when seeking reconsideration; a request for reconsideration may be oral or written.

Registrants also may ask the SEC’s Office of the Chief Accountant (OCA), which is distinct from the DCF’s Office of Chief Accountant, to reconsider an accounting conclusion of the DCF staff at any stage in the process. Generally, the Commission’s Office of the Chief Accountant addresses questions about the application of US GAAP while DCF resolves matters concerning the age, form and content of financial statements required to be included in a filing. Even before a registrant requests reconsideration, DCF staff may have consulted internally about the issue with DCF-OCA and then with the OCA.

A registrant should initiate a reconsideration with OCA by informing the staff in DCF of its intention to request such reconsideration. In these circumstances, a registrant does not need to make a submission directly to OCA if all of the relevant information already is contained in comment letter responses from the registrant to DCF, although a separate submission to OCA may serve to expedite the process.

Disclosure requirements

The SEC requires that all entities defined as an accelerated filer, a large accelerated filer or a well-known seasoned issuer disclose, in their annual reports on Form 10-K or Form 20-F, written comments DCF staff has made in connection with a review of Exchange Act reports that:

- The registrant believes are material
- Were issued more than 180 days before the end of the fiscal year covered by the annual report
- Remain unresolved as of the date of the filing of the Form 10-K or Form 20-F
The disclosure must identify the substance of the unresolved comments. DCF staff comments that have been resolved, including those that DCF staff and the registrant have agreed will be addressed in future Exchange Act reports, do not need to be disclosed. Registrants can provide other information, including their positions regarding any such unresolved comments. This information is not required in the registrant’s quarterly reports on Form 10-Q.

Requests for waivers, pre-clearance and interpretive guidance

DCF staff has reminded registrants that it is better to “seek permission than ask for forgiveness” as it relates to SEC reporting. To help reduce the risk of being questioned in the comment process on a complicated reporting matter, registrants may “pre-clear” their questions regarding financial reporting and disclosure information with DCF staff by submitting a formal pre-clearance request in writing on a named basis. DCF staff generally responds in writing to formal requests made in writing on a named basis within 10 business days.

Registrants also may request informal interpretive guidance from DCF staff on a named or no named basis in a telephone call to DCF staff or in a request form for interpretive guidance and other assistance on the SEC’s website. Requests made by telephone or an online request form are informal and may remain anonymous; however, responses to such requests cannot be relied upon as formal positions of DCF staff.

In addition, companies may pre-clear conclusions on the application of US GAAP (or IFRS) with the Commission’s Office of the Chief Accountant. OCA staff encourages companies to consult on a pre-fling basis when the company is uncertain about accounting issues. Further discussion of the procedures for consulting with OCA is on the SEC’s website at [http://www.sec.gov/info/accountants/ocasubguidance.htm](http://www.sec.gov/info/accountants/ocasubguidance.htm).

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13 The online request form is available at: [https://tts.sec.gov/cgi-bin/corp_fin_interpretive](https://tts.sec.gov/cgi-bin/corp_fin_interpretive).
## Appendix E: Abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>FASB Accounting Standards Codification</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASC 230</td>
<td>FASB ASC Topic 230, <em>Statement of Cash Flows</em></td>
</tr>
<tr>
<td>ASC 235</td>
<td>FASB ASC Topic 235, <em>Notes to Financial Statements</em></td>
</tr>
<tr>
<td>ASC 250</td>
<td>FASB ASC Topic 250, <em>Accounting Changes and Error Corrections</em></td>
</tr>
<tr>
<td>ASC 260</td>
<td>FASB ASC Topic 260, <em>Earnings Per Share</em></td>
</tr>
<tr>
<td>ASC 280</td>
<td>FASB ASC Topic 280, <em>Segment Reporting</em></td>
</tr>
<tr>
<td>ASC 310</td>
<td>FASB ASC Topic 310, <em>Receivables</em></td>
</tr>
<tr>
<td>ASC 350</td>
<td>FASB ASC Topic 350, <em>Intangibles – Goodwill and Other</em></td>
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<tr>
<td>ASC 350-20</td>
<td>FASB ASC Topic 350-20, <em>Intangibles – Goodwill and Other – Goodwill</em></td>
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<td>ASC 405</td>
<td>FASB ASC Topic 405, <em>Liabilities</em></td>
</tr>
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<td>ASC 450</td>
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</tr>
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<td>FASB ASC Topic 470-20, <em>Debt – Debt with Conversion and Other Options</em></td>
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<td>FASB ASC Topic 470-50, <em>Debt – Modifications and Extinguishments</em></td>
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<td>FASB ASC Topic 470-60, <em>Debt – Troubled Debt Restructurings by Debtors</em></td>
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<td>ASC 480</td>
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<td>FASB ASC Topic 605-25, <em>Revenue Recognition – Multiple-Element Arrangements</em></td>
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<td>ASC 605-28</td>
<td>FASB ASC Topic 605-28, <em>Revenue Recognition – Milestone Method</em></td>
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<td>FASB ASC Topic 605-45, <em>Revenue Recognition – Principal Agent Considerations</em></td>
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<tr>
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<td>FASB ASC Topic 606, <em>Revenue Recognition – Revenue from Contracts with Customers</em></td>
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<tr>
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<tr>
<td>ASC 805</td>
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<td>FASB ASC Topic 810, <em>Consolidation</em></td>
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<td>FASB ASC Topic 970, <em>Real Estate – General</em></td>
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<td>Exchange Act Industry Guide 7, <em>Description of Property by Issuers Engaged or To Be Engaged in Significant Mining Operations</em></td>
</tr>
</tbody>
</table>
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