

SEC Reporting Update

2018 trends in SEC comment letters

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What you need to know

- ▶ The number of comment letters issued by the SEC staff continued to decline, but the adoption of new accounting standards could slow or reverse that trend.
- ▶ Over the next year, the SEC staff is expected to focus on accounting under the new revenue standard, disclosures about how companies will be affected by new standards on leases and credit impairment, disclosures about cybersecurity and accounting for income tax reform.
- ▶ In comment letters to early adopters of the new revenue standard, the SEC staff has focused on areas of judgment such as identifying performance obligations, determining the timing of satisfaction of performance obligations and determining the categories to present as disaggregated revenue.
- ▶ Management's discussion and analysis was the most frequent area of comment in the period ended 30 June 2018, edging out non-GAAP financial measures.
- ▶ Understanding SEC comment letter trends and best practices for responding to letters can help companies plan for year-end reporting and identify disclosure improvements. However, companies shouldn't make disclosures solely to avoid a comment letter.

Overview

The number of comment letters the Securities and Exchange Commission (SEC or Commission) staff issued to registrants continued to decline, falling 25% in the year ended 30 June 2018, but the adoption of new accounting standards could slow or reverse that trend.

Over the coming year, we expect the SEC staff to focus on companies' accounting under the new revenue recognition standard and disclosures about the effects of the new accounting standards on leases and credit impairment. The staff is also expected to focus on disclosures about cybersecurity and accounting for the effects of income tax reform.

In its comment letters issued to early adopters of the new revenue standard, the SEC staff has focused on areas of judgment (e.g., identifying performance obligations, determining the timing of satisfaction of performance obligations, determining the categories to present as disaggregated revenue). These comments may indicate areas the SEC staff will focus on when reviewing filings by the much larger population of registrants that adopted the standard in 2018.

For the period ended 30 June 2018, management's discussion and analysis (MD&A) was back in the top spot as the most frequent area of comment, moving slightly ahead of non-GAAP financial measures; however, the top 10 most frequent comment areas for 10-K filings remained largely the same as in 2017.

This publication addresses trends in SEC staff comment letters issued in the year ended 30 June 2018 and highlights areas that we expect the staff to focus on in the coming year. We also summarize best practices that may help companies respond to SEC staff comment letters. Our publication, [2018 SEC Comments and Trends: an analysis of current reporting issues](#), discusses the SEC staff's focus areas in more detail and provides information about SEC staff comments that are unique to certain industries, initial public offering registration statements and foreign private issuers.

While this publication highlights areas where the SEC staff has commented in the past, it is not intended to drive changes to a company's accounting or disclosure unless the company determines that changes are necessary to comply with the accounting or disclosure requirements. However, this publication may help a company identify disclosure improvements or enhance its documentation of its accounting conclusions.

We recommend that companies refrain from making decisions about disclosures solely to avoid a comment letter. If you receive a comment letter from the SEC staff, view it as an opportunity to educate the staff about your facts and how you arrived at the conclusions leading to your disclosure, which may include clarifying your consideration of materiality. Following the best practices discussed in this publication often leads to a relatively short dialogue with the SEC staff. We also note that many companies resolve comments without changing their disclosures.

Expected areas of focus

New revenue recognition standard (ASC 606)

In our study of recent SEC staff comments, we analyzed the comment letters that were issued to certain early adopters of Accounting Standards Codification (ASC) 606¹ and ASC 340-40² that may indicate the types of comments the SEC staff will issue to registrants that adopted the standard this year. As expected, the SEC staff's comments on the application of ASC 606 and ASC 340-40 have focused on areas of judgment. Based on what we have seen, registrants appear to have been able to resolve these comments in the same manner they have resolved comments on other topics. That is, the registrants have helped the SEC staff gain a better understanding of the judgments made by management or agreed to provide additional disclosures in future filings. Contemporaneous documentation of the judgments made in applying the new revenue standard will help facilitate the dialogue with the SEC staff during the comment process.

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The SEC staff has asked registrants how they identify their performance obligations in contracts with customers. In particular, the SEC staff is interested in how registrants support their conclusions that certain promised goods and services are not separately identifiable.

Example SEC staff comment: Identifying performance obligations

We note some of your contracts have multiple performance obligations. Please tell us and revise to disclose the nature of these performance obligations pursuant to ASC 606-10-50-12(c). For maintenance, support and warranty services, please provide us with your analysis as to why these services were not separately identifiable in accordance with the guidance of ASC 606-10-25-21, as applicable.

ASC 606 requires entities to disclose the method used to recognize revenue (e.g., a description of the input or output methods used and how those methods are applied) and why the method selected provides a faithful depiction of the transfer of goods or services. The SEC staff has commented when registrants have not included the latter disclosure.

Example SEC staff comment: Satisfaction of performance obligations

You disclose you recognize revenue over time using an input measure (e.g., costs incurred to date relative to total estimated costs at completion). Revise to disclose why this method is a faithful depiction of the transfer of goods or services pursuant to ASC 606-10-50-18(b).

The SEC staff also has asked registrants about their disaggregated revenue disclosures and how the categories for disaggregation were determined in accordance with the disclosure requirements in ASC 606. Similar to how it reviews segment disclosures, the SEC staff may review all publicly available information to evaluate whether the objectives of this disclosure requirement have been met.

Example SEC staff comment: Disaggregated revenue disclosures

We note your presentation of disaggregated revenue by major source on page XX. With respect to the disclosure requirements of ASC 606-10-50-5, please tell us how you considered the guidance in paragraphs ASC 606-10-55-89 through 55-91 in selecting the appropriate categories to use to disaggregate revenue. Please tell us why you believe your current disclosures meet the objective of depicting how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors.

The SEC staff has noted that the adoption of the new revenue standard is a significant change for many registrants and said that it is monitoring the new disclosures mandated by ASC 606 and encouraging companies to refine and supplement their annual disclosures included in their quarterly filings in the year of adoption.

Accounting transition disclosures under SAB Topic 11.M

With registrants preparing to adopt new standards on leases and credit impairment, SEC officials have continued to emphasize the disclosures registrants should provide to comply with Staff Accounting Bulletin (SAB) Topic 11.M (issued as SAB 74) and the announcement the SEC staff made in 2016 regarding its expectations for disclosures about how companies will be affected by the new standards.

The SEC staff expects registrants to include a description of the process they used to assess the effect of a new standard, indicate where they are in the implementation process and what matters still need to be addressed, and identify the additional steps they plan to take.

The SEC staff also expects a registrant's disclosures to evolve as the effective date of a new standard nears and the registrant makes progress on its implementation plan. That is, the SEC staff expects a registrant's disclosures to be more specific each quarter.

Example SEC staff comment: SAB 74 disclosure

You state that you are in the process of evaluating the impact that ASC 842, *Leases*, will have on your consolidated financial statements. Please revise to provide a qualitative discussion of the potential impact that this standard will have on your financial statements when adopted. In this regard, include a description of the effects of the standard that you expect to apply and a comparison to your current lease accounting and disclosure policies. Describe the status of your process to implement the new standard and the significant implementation matters yet to be addressed. In addition, to the extent that you determine the quantitative impact that adoption of ASC 842, *Leases*, will have on your results or financial position, please also disclose such amounts.

Accounting for US tax reform

SEC staff members have said they are monitoring disclosures companies make under SAB 118 as the deadline for companies to complete their accounting for the enactment-date income tax effects of the Tax Cuts and Jobs Act (Act) approaches.

The SEC staff issued the SAB to provide an accommodation for registrants that could not complete their accounting for the income tax effects of the Act under ASC 740 in the period of enactment (i.e., the period including 22 December 2017). The SAB gave registrants a measurement period of up to one year to obtain, prepare and analyze the information needed and required detailed disclosures of their progress.

In a recent speech, Sagar Teotia, the SEC's Deputy Chief Accountant, noted that the SAB does not provide a deferral and said the SEC staff expects companies to "keep moving in good faith" to complete their accounting as soon as they can. "This should not be interpreted as a window to put pencils down until we are close to one year from the enactment date to get started on the accounting," he said.

These comments suggest that the SEC staff could raise questions if a registrant records significant changes to its provisional amounts toward the end of the measurement period or has not updated provisional amounts recorded in the period of enactment. That is, the SEC staff could ask such a registrant to provide supplemental information about whether it has appropriately disclosed the material financial reporting effects of the Act for which the accounting was incomplete or request additional information supporting the timing of when the company recorded an adjustment to provisional amounts.

The SEC staff has issued these types of comments in the past when registrants have made significant changes to provisional amounts recorded during the measurement period allowed in accounting for business combinations.

Cybersecurity

SEC Chairman Jay Clayton has asked the Division of Corporation Finance (DCF) to carefully monitor cybersecurity disclosures. He made the request when the Commission issued new interpretive guidance³ on cybersecurity in February 2018 that largely incorporates the staff's 2011 cybersecurity disclosure guidance and builds on the previous guidance in important ways.⁴ For example, the new guidance helps companies apply the concept of materiality to cybersecurity risks and incidents, and it includes a more comprehensive list of disclosure items for companies to consider. The new guidance also focuses on companies' policies and procedures related to cybersecurity.

In his statement on the new guidance, Mr. Clayton said, “There is no doubt that the cybersecurity landscape and the risks associated with it continue to evolve. I have asked the Division of Corporation Finance [DCF] to continue to carefully monitor cybersecurity disclosures as part of their selective filing reviews. We will continue to evaluate developments in this area and consider feedback about whether any further guidance or rules are needed.”⁵

How we see it

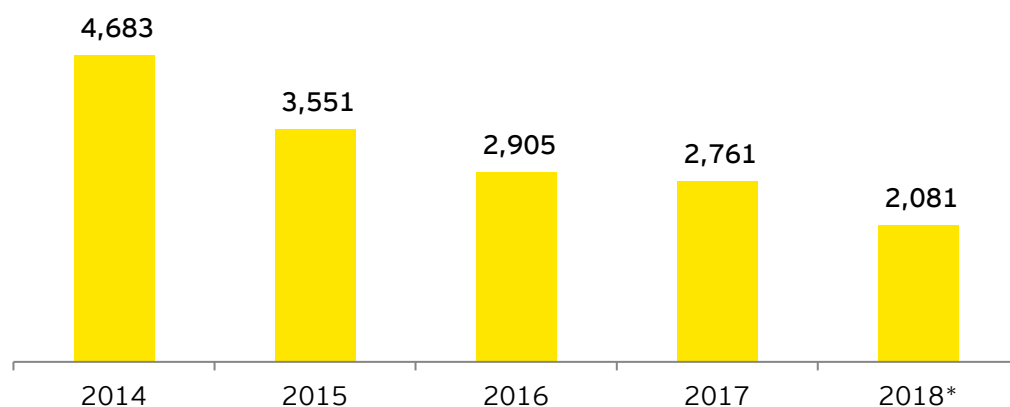
In light of the new guidance on cybersecurity and the evolving landscape of cyber risks and cybersecurity, companies should take a fresh look at their cybersecurity disclosures.

General observations

Number of SEC staff comment letters continues to decline

The volume of SEC staff comment letters in the year ended 30 June 2018 declined around 25% from the previous year, continuing the trend in recent years. In the latest period, the SEC staff issued less than half the number of comment letters it did in the annual period ended 30 June 2014.

Number of SEC comment letters by year



Source: Audit Analytics – SEC UPLOAD comment letters issued related to Forms 10-K and 10-Q for the 12-month periods ended 30 June 2014 through 30 June 2018.

* The SEC staff publicly releases comment letters no earlier than 20 business days after it completes its review. Therefore, some letters for the 12-month period ended 30 June 2018 may not yet be publicly available.

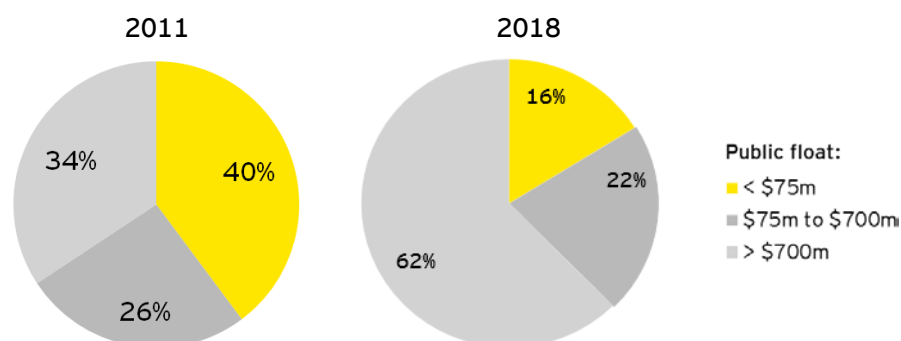
Nearly half of the decrease in comment letters in 2018 appears to be attributable to the decline in the number of comments issued to registrants on non-GAAP measures. The number of comment letters on non-GAAP measures has declined significantly as many registrants have improved their non-GAAP disclosures following the SEC staff’s updated guidance on non-GAAP disclosures issued in May 2016 and the related comment letter process that followed in 2017.

The decline in the number of SEC comment letters also may be attributable to the fact that the SEC staff is focusing more on material items in the comment letters before issuing comments and has been reviewing large registrants more frequently in recent years. The Sarbanes-Oxley Act of 2002 requires that the SEC staff review every registrant at least once every three years. The SEC staff reviews many registrants more frequently, but they do not always receive letters.

In recent years, the SEC staff has used a risk-based approach, which involves concentrating on larger issuers and reviewing their filings each year. These larger companies represent a relatively small percentage of the total number of registrants, but they account for substantially all of the US equity market capitalization. More regular reviews of larger companies decreases the likelihood that there will be issues worthy of comment in every review because comments are often triggered by significant transactions or events or other factors that cause changes in disclosure. While the SEC staff still must review smaller companies, it may be more judicious in issuing comments to those companies given the lower risk to the overall market.

As this chart shows, the comments issued to non-accelerated filers decreased substantially to 16% of the total in 2018 from 40% in 2011.

Size of registrants receiving comment letters on Form 10-K filings



Source: Audit Analytics – SEC UPLOAD comment letters issued related to Forms 10-K for the 12-month periods ended 30 June 2011 and 30 June 2018.

The SEC staff continues to comment most often on accounting areas that require significant judgments and estimates.

Most frequent comment areas

The following chart summarizes the top 10 most frequent comment areas in the current and previous years.

Comment area	Ranking 12 months ended 30 June		Comments as % of total registrants that received comment letters*
	2018	2017	2017 and 2018
Management's discussion and analysis**	1	2	43%
Non-GAAP financial measures	2	1	47%
Fair value measurements***	3	3	17%
Segment reporting	4	4	15%
Revenue recognition	5	5	13%
Intangible assets and goodwill	6	6	11%
State sponsors of terrorism	7	8	12%
Income taxes	8	7	12%
Acquisitions and business combinations	9	9	8%
Contingencies	10	****	6%

* These rankings are based on topics assigned by research firm Audit Analytics for SEC comment letters issued to registrants about Forms 10-K from 1 July 2016 through 30 June 2018. In some cases, individual SEC staff comments are assigned to multiple topics if the same comment covers multiple accounting or disclosure areas.

** This category includes comments on MD&A topics, in order of frequency: (1) results of operations (20%), (2) critical accounting policies and estimates (10%), (3) liquidity matters (8%), (4) business overview (6%) 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 ASC 820, *Fair Value Measurement*, as well as fair value estimates, such as those related to revenue recognition, stock compensation and goodwill impairment analyses.

**** This topic was not among the top 10 in 2017.

Consistent comment areas

Management's discussion and analysis

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

To help investors view the registrant through the eyes of management, the SEC's guidance on MD&A suggests that the registrant disclose in MD&A the key performance indicators, financial or nonfinancial, that are used to manage its 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 often focus on the number of monthly or daily users. The SEC staff may ask a registrant to disclose key performance indicators in its SEC filings if the registrant cites the indicators on its website, in a press release or analyst presentation or in another setting.

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

We note your reference, both in your risk factor disclosures and on your earnings calls, to the impact of capacity utilization rates on your financial condition and results of operations. To the extent that utilization rates are a key performance indicator used in managing your business, please include a discussion of this measure along with comparative period amounts or explain why you do not believe this disclosure is necessary.

Refer to Section III.B.1 of SEC Release No. 33-8350.

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

- ▶ Define the metric, especially when a registrant's definition differs from the definition commonly used in its industry
- ▶ Discuss how the metric is calculated
- ▶ Discuss any limits on the usefulness of the metric (e.g., individuals may be counted more than once in an "average monthly users" metric)
- ▶ 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 operating results to reveal a trend (e.g., using the increase in the number of customers to explain revenue growth)

The SEC staff has asked for clarification when it believes that a registrant's use of such metrics without the appropriate context is potentially misleading and does not appropriately explain any changes in income statement line items. For example, if a company discloses that it has 10 million total users and expects the number to grow 12% but doesn't explain that the majority of them are nonpaying, investors may mistakenly expect a direct correlation between total user growth and profitability.

The SEC staff also continues to ask registrants to quantify the effects of factors that contributed to material period-to-period changes, including the underlying business or economic factors and material offsetting factors, and provide a more granular discussion of the effects. For example, when a registrant discloses that two or more factors contributed to a material period-to-period change in a financial statement line item, the SEC staff often requests that the registrant quantify and analyze each factor's effect.

Example SEC staff comment: Results of operations – quantification of factors

We note that your comparative discussions of costs and expenses identify multiple variables as the reasons for the period-to-period changes in your operating results. However, you do not quantify the impact of each of these variables.

Please revise to quantify the impact of each material factor that you discuss to provide your readers with better insight into the underlying reasons behind the changes in your results. Refer to Instruction 4 to Item 303(a) of Regulation S-K, Section III.D of Release No. 33-6835 and Section III.B of Release No. 33-8350.

The SEC staff continues to note that registrants' disclosures about critical accounting estimates often are too general and should provide a more robust analysis than what is in the significant accounting policies note 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

The disclosure of critical accounting policies within MD&A appears to duplicate your accounting policy disclosure in the notes to your financial statements, and it does not provide investors with a robust discussion of your critical estimates by focusing on the assumptions and uncertainties that underlie the impairment analysis of your most significant asset.

Non-GAAP financial measures

The SEC staff's comments on non-GAAP financial measures are consistent with what we observed in the prior year after the SEC staff made its guidance on non-GAAP measures more explicit in an update to its Compliance and Disclosure Interpretations (C&DIs) in May 2016.

The SEC staff has asked registrants to explain how their use of non-GAAP financial measures complies with the C&DIs or to change their presentation of items, including:

- ▶ Non-GAAP financial measures that tailor GAAP recognition and measurement principles, don't include the same items in all periods, don't treat similar gains and losses consistently or exclude normal cash operating expenses from performance measures
- ▶ Non-GAAP financial measures that are presented more prominently than GAAP measures or disclosures that don't appear to comply with Item 10(e) of Regulation S-K (e.g., presenting a measure that could be misleading, omitting disclosure of the measure's usefulness to investors or management, removing cash-settled charges from liquidity measures, labeling recurring items as nonrecurring)

Many of the SEC staff comments have focused on registrants' use of non-GAAP financial measures in earnings releases and other information (e.g., websites, investor presentations) in addition to their SEC filings.

While the SEC staff initially focused on alternative measurements of revenue as the source of misleading non-GAAP performance measures that tailor GAAP accounting principles, the SEC staff has broadened its approach and challenged other ways registrants modify GAAP recognition and measurement principles in calculating non-GAAP financial measures such as the use of proportionate consolidation for equity investees, accounting for operating leases as capital leases or eliminating the provision for loan losses.

We expect this issue to continue to receive attention if companies present non-GAAP financial measures that unwind the effects of new accounting standards (for purposes other than providing the required transition disclosures).

Example SEC staff comment: tailoring recognition of allowance for loan losses

We note the disclosure of the non-GAAP measure "adjusted allowance for loan losses/non-acquired loans held for investment." We also note you eliminated the allowance for loans losses attributable to XX. Tell us how you considered whether the non-GAAP measure uses an individually tailored recognition and measurement method, which could violate Rule 100(b) of Regulation G. Please refer to Question 100.04 of the Compliance and Disclosure Interpretations for guidance.

The SEC staff continues to question compliance with Item 10(e) of Regulation S-K in comments about the clarity of labeling adjustments to GAAP, terms registrants use to describe non-GAAP measures that are similar to GAAP, presenting non-GAAP financial measures with greater prominence than GAAP measures and disclosures about the usefulness of non-GAAP financial measures.

Example SEC staff comment: Prominence of non-GAAP measures

We note that you present non-GAAP earnings and non-GAAP margin before the most directly comparable GAAP measures. Your presentation appears to give greater prominence to the non-GAAP measures than to the comparable GAAP measures, which is inconsistent with the updated C&DIs issued on May 17, 2016. Please review that guidance when preparing future earnings releases.

Example SEC staff comment: Usefulness of a non-GAAP measure

Please include substantive statements disclosing the reasons why management believes presentation of each non-GAAP measure provides useful information to investors. Those disclosures should be specific and substantive to each measure.

Refer to Item 10(e)(1)(i)(c) and SEC Release 33-8176 (FR-65).

Fair value measurements

Fair value measurement continues to be a frequent area of scrutiny by the SEC staff. In its comments on registrants' compliance with fair value measurement disclosure requirements, the SEC staff asks registrants to provide more robust disclosures about the valuation techniques and inputs they use in determining fair value, including valuation techniques and inputs used by third parties.

While the SEC staff has been less vocal on non-GAAP financial measures in 2018, it continues to issue comments on this topic.

The SEC staff's questions continue to be granular, frequently focusing on specific inputs to a fair value measurement. For example, the SEC staff may inquire about the basis for the valuation methodology applied and the basis for inputs used in the valuation, such as discount rates, selected valuation multiples, cash flow forecasts and discounts or 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). In other instances, the SEC staff asks registrants to explain the basis for the valuation methods used to allocate the purchase price among acquired tangible and intangible assets in a business combination.

Example SEC staff comment: Valuation methodology and inputs

Tell us in reasonable detail how you determined the fair value of your reporting unit. Please include the specific methods utilized. Tell us the material assumptions used under each method utilized. Examples might include how cash flows were estimated, which discount rate was used and which principal market and market participants were selected. Please make sure your response addresses how you determined that each of the assumptions used was appropriate.

The SEC staff continues to ask registrants to describe the procedures they perform to validate the fair value measurements obtained from third-party pricing services, including how they concluded bid quotes were a reliable indicator of fair value.

Example SEC staff comment: Third-party pricing information

We note you disclose that you determine the fair value of your investment securities based upon fair value estimates obtained from multiple third-party pricing services and dealers. Also, we note your disclosure that third-party pricing sources use various valuation approaches, including market and income approaches, and you disclose various inputs but no specific techniques. Please describe the specific valuation techniques used, and the inputs applicable to such valuation techniques, to determine the fair value of securities categorized within Level 2.

Segment reporting

The SEC staff continues to focus on segment disclosures and the application of ASC 280, *Segment Reporting*, including the basic objectives and principles outlined in the segment reporting guidance.

When reviewing segment reporting, the SEC staff considers information in the registrant's public filings as well as information available from a registrant's earnings calls, website and industry or analyst presentations. The SEC staff has asked registrants to explain any inconsistencies between how the business is described in public information and how it is described in their segment notes. For example, the SEC staff has challenged registrants when they say the basis for identifying operating segments is something other than product or service lines (e.g., geography) but publicly disclosed information suggests that 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 and has inquired about changes in the business that could affect the identification or aggregation of operating segments.

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 employees who report directly to the chief operating decision maker (CODM), 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 how the CODM assesses performance and allocates resources.

Further, when a registrant identifies only one operating segment, the SEC staff has challenged how decisions can be made about performance and resources for the company as a whole without evaluating discrete financial information on a more disaggregated basis. The SEC staff has said that if the application of the guidance in ASC 280 results in the identification of a single operating segment, a registrant should disclose that it allocates resources and assesses financial performance on a consolidated basis and explain the basis for that management approach.

Example SEC staff comment: Identification of operating segments

Please tell us who your 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:

- ▶ Tell us the nature of the resource allocation and performance assessment decisions the CODM makes, including examples to illustrate the description.
- ▶ Describe the information regularly provided to the CODM and how frequently it is prepared.
- ▶ Describe the information regularly provided to the Board of Directors and how frequently it is prepared.
- ▶ Explain how budgets are prepared, who approves the budget at each step of the process, the level of detail discussed at each step and the level at which the CODM makes changes to the budget. Also describe the level of detail communicated to the CODM when actual results differ from budgets and who is involved in the meetings with the CODM to discuss budget-to-actual variances.
- ▶ Describe the basis for determining the compensation of the individuals that report to the CODM.

It's important to understand that while the identification of operating segments follows a management approach, the aggregation of operating segments should be viewed from the investor's perspective. The SEC staff has said that it is important for registrants to consider information such as industry reports and other analyses by users of the financial statements that may provide evidence of how a reasonable investor would analyze the company.

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 SEC staff has said that the expectation that operating segments will have similar economic characteristics (e.g., long-term average gross margins) in the future does not overcome a lack of similarity in their current and past performance.

The SEC staff considers meeting the criteria to aggregate operating segments a high hurdle.

The SEC staff often reviews the registrant's website, analyst presentations and information in public filings and raises questions if any of that information is inconsistent with the registrant's conclusion that aggregating operating segments is appropriate. For example, a discussion of diverging trends or differing results at two business lines could indicate that these two business lines, if they qualify as operating segments, may not be economically similar. The SEC staff has also requested 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 has frequently asked for an explanation of why the registrant believes the five qualitative characteristics of the operating segments are similar, as required by ASC 280.

Example SEC staff comment: Aggregation of operating segments

We note that your five operating segments are aggregated into one reportable segment. Please address the following:

- ▶ Compare and contrast your operating segments relative to the areas listed in ASC 280-10-50-11(a) through (e). With respect to any differences among your operating segments, tell us why you determined that disaggregation was not warranted.
- ▶ Provide us with each operating segment's historical and projected revenues, gross margin, operating margin and measure of segment profitability.
- ▶ Tell us the basis of organization (i.e., why the company is organized in the manner that it is).

We continue to see a high level of staff focus in this area, even when the staff has previously commented on a registrant's segment reporting. Questions on segment reporting have often resulted in multiple rounds of comments, particularly when the registrant's initial response was not comprehensive. The SEC staff considers meeting the criteria to aggregate operating segments a high hurdle.

How we see it

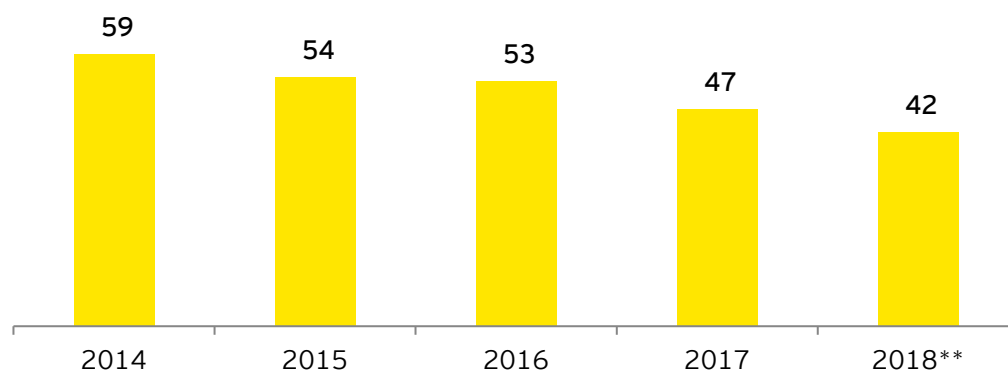
Companies should challenge any conclusions they reach on operating segments that are inconsistent with their basic organizational structure, other public information, changes in the business environment or the level of disaggregation used by the CODM in making key operating decisions. In addition, companies should consider the processes the CODM uses to evaluate performance and allocate resources, including the CODM's interaction with direct reports, the basis on which budgets and forecasts are prepared, how executive compensation is determined (e.g., the performance criteria underlying compensation plans) and the related internal controls.

Companies should be prepared to respond to questions from the SEC staff whenever they make changes in their segment reporting or make changes in the business that may indicate that segment disclosures should change.

SEC comment letter best practices

The average number of days it takes to resolve SEC staff comments has declined in recent years. For example, it took an average of 17 fewer days (i.e., almost a 30% decline) to close a comment letter in the year ended 30 June 2018 compared to the same period in 2014.

Average days to close a comment letter*



Source: Audit Analytics

* The number of days it took to close a comment letter was calculated as the difference between the date of an initial letter and the closing letter date.

** This does not include comments issued in 2018 but not yet closed.

A thoughtful and well-written response letter is important to resolve SEC staff comments timely. When responding to DCF staff comment letters, registrants should consider the following:

- ▶ Registrants should assume that DCF staff has not yet concluded on a matter and merely needs more information, unless the staff clearly indicates in its comment this is not the case.
- ▶ 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 and provide insight into any judgments made. While it may be helpful to consider responses from other registrants on similar topics, registrants should not copy those responses.
- ▶ 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 disclosure will be modified in a future filing, it can be helpful for the registrant to provide proposed language in its response letter. Registrants should make it clear that facts and circumstances may change in a way that could require disclosure different than that proposed.
- ▶ Companies should seek the input of all appropriate internal personnel and professional advisers (such as legal counsel and independent auditors) so that they fully respond to the comment letter in a complete and accurate manner. Waiting for a later round of comments to involve the necessary resources may delay or hinder a successful resolution.

Providing a thorough explanation or analysis of an issue to the SEC staff beyond the existing disclosure may help the staff better understand the accounting and disclosure, and it often will resolve the comment without adding more disclosure. To facilitate such responses,

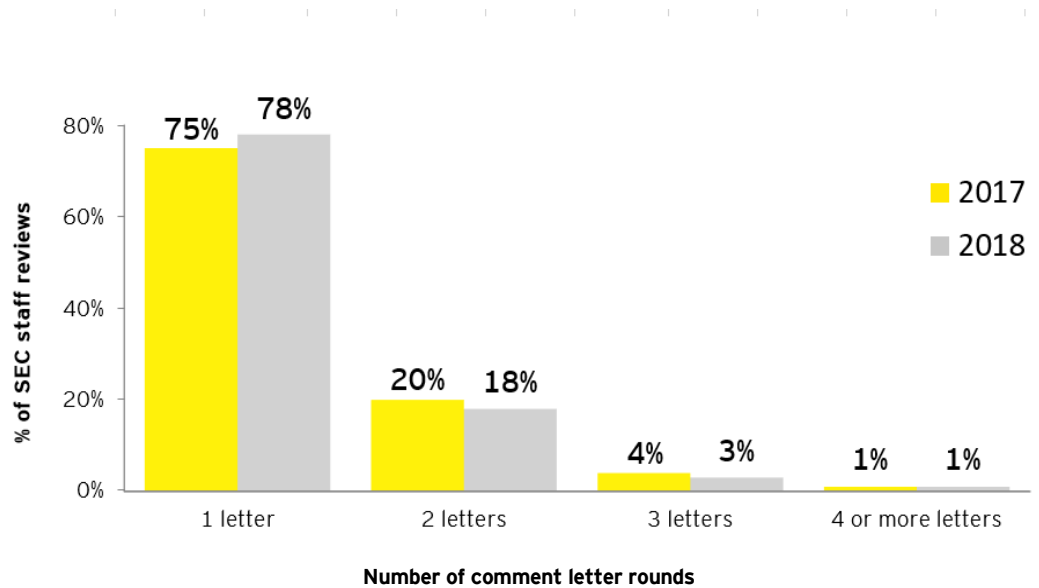
registrants should maintain contemporaneous documentation of significant accounting and disclosure decisions. Judgment applied and documented contemporaneously is more persuasive than a retrospective defense following receipt of an SEC staff comment.

While SEC staff comment letters often request a response within 10 business days, companies should not hesitate to request an extension if more time will enhance the quality of their response.

Consistent with last year, slightly over three quarters of the reviews were completed with only one round of comments (i.e., a letter from the SEC staff and a response from the company) and nearly all are resolved after two letters in the 12 months ended 30 June 2018.

Proactive communication with the SEC staff may expedite the comment letter process.

Number of comment letters issued to complete review



Source: Audit Analytics – SEC UPLOAD comment letters (excluding “completion of review” letters) related to Forms 10-K posted to EDGAR during the 12-month periods ended 30 June 2017 and 2018.

We have also found that holding a live discussion with the SEC staff rather than communicating exclusively in writing can help resolve a difficult comment. For example, if a comment remains outstanding after two rounds of comments, a company might consider requesting a conference call to discuss the issues.

Endnotes:

- ¹ ASC 606, *Revenue from Contracts with Customers*.
- ² ASC 340-40, *Other Assets and Deferred Costs – Contracts with Customers*.
- ³ Commission statement and guidance on public company cybersecurity disclosures. The text is available at <https://www.sec.gov/rules/interp/2018/33-10459.pdf>.
- ⁴ [SEC Reporting Update, SEC issues guidance on cybersecurity](#).
- ⁵ SEC Chairman Clayton’s statement on the Commission’s cybersecurity guidance. The text is available at <https://www.sec.gov/news/public-statement/statement-clayton-2018-02-21>.

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