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SEC Reporting Update

Highlights of trends in 2019 SEC comment letters

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What you need to know

- Revenue recognition rose to the top spot in our list of the most frequent topics in SEC staff comment letters for the year ended 30 June 2019.
- The SEC staff continues to challenge non-GAAP measures, especially those employing individually tailored accounting principles that may be misleading.
- While the number of comment letters issued by the SEC staff continued to decline, the 34% drop in the latest year was likely affected by the partial government shutdown in December and January.
- Over the next year, we expect the SEC staff to continue to focus on accounting and disclosures related to new accounting standards (leases and credit impairment) and disclosures about the potential effects of Brexit and the anticipated phase out of LIBOR, among other topics.

Overview

Revenue recognition rose to the top of the list of topics the Securities and Exchange Commission (SEC) staff raised questions about in comment letters for the year ended 30 June 2019.

This trend isn't surprising because most companies reflected their adoption of the new revenue standard[1] in their annual financial statements for the first time in their 2018 annual reports. In the year ended 30 June 2019, registrants' use of non-GAAP measures was once again the second most frequent topic addressed in staff comment letters.

EY resources

- SEC Reporting Series, ***2019 SEC Comments and Trends: an analysis of current reporting issues***

Building a better working world

This publication focuses on key trends in SEC staff comment letters issued for the year ended 30 June 2019 and the outlook for next year. Our publication ***2019 SEC Comments and Trends: an analysis of current reporting issues*** discusses the SEC staff's focus areas in more detail and summarizes best practices that may help companies respond to SEC staff comment letters.

Understanding SEC staff comment areas may help a company identify ways to improve its disclosures or enhance the documentation of its accounting conclusions. However, it is important to recognize that each company must consider its own facts and circumstances, including materiality, before making any changes to its accounting or disclosure.

Revenue recognition

In its first year of reviewing how a wide range of registrants applied the new revenue standard and related cost guidance, the SEC staff focused on areas of judgment and asked registrants how they:

- Identified performance obligations in contracts with customers, including how they support their conclusions that certain promised goods and services are or are not separately identifiable
- Determined whether they are a principal or an agent in contracts with customers, including defining the nature of the goods or services being provided to the customer and defining the registrant's role in providing the good or service to the customer
- Estimated variable consideration when determining the transaction price in contracts with customers, including how they estimated different forms of variable consideration and how they applied the constraint
- Met the criteria to apply the residual approach to estimate the standalone selling price of a promised good or service, including requests that the registrant provide a comprehensive, quantitative analysis to support a conclusion that its pricing for a good or service is highly variable or uncertain
- Satisfied performance obligations (i.e., over time or at a point in time) and why the method they used to measure progress toward satisfaction of an over-time performance obligation provides a faithful depiction of the transfer of goods or services in a contract with a customer
- Disaggregated revenue disclosures and determined the categories for disaggregation

The following examples illustrate the types of questions the SEC staff asked about these areas of judgment.

Example SEC staff comment: Identifying performance obligations
You disclose that "many" of your contracts have a single performance obligation. Please help us understand the nature of the goods and services transferred in these contracts and provide us with your analysis regarding how you determined that the goods and services in these contracts should be combined. Refer to Accounting Standards Codification (ASC) 606-10-25-19 through 22.

Example SEC staff comment: Principal vs. agent considerations

We note your disclosure that when more than one party is involved in providing services to a customer, you generally act as the principal and report revenue on a gross basis. Please tell us which arrangements involve third parties and tell us how you determined you control each service before it is transferred to the customer. In addition, we note your disclosure in management's discussion and analysis (MD&A) regarding agent commissions. Please help us understand the nature of these agent services. Reference ASC 606-10-55-36 through 40. ASC 606-10-50-12(c) requires entities to disclose the nature of the goods or services that they have promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services (i.e., if the entity is acting as an agent).

Example SEC staff comment: Variable consideration

We note from your disclosure that net revenues refers to your operating revenues from the sale of products, including shipping and handling charges billed to customers, net of sales and promotion incentives, and excise taxes. In light of the fact that the incentives appear to represent variable consideration, please tell us and revise to disclose the nature of all variable consideration and how you estimate the variable consideration, including whether this estimate is typically constrained. See ASC 606-10-50-12(b) and ASC 606-10-50-20. In this regard, we also note from your earnings calls that you may have loyalty programs associated with certain of your products, which also may be sold with discounts. Please note that these programs should be considered in your variable consideration analysis.

Example SEC staff comment: Use of the residual method

You disclose that the selling prices of your software licenses are highly variable, and you use the residual approach to estimate standalone selling price. Please provide a comprehensive, quantitative discussion of such variability to support your conclusion and explain how you met one of the criteria in ASC 606-10-32-34(c).

Example SEC staff comment: Satisfaction of performance obligations

We note your disclosure for your identified performance obligations that revenue is recognized when, or as, the performance obligation is satisfied. Please tell us and revise to clarify if revenue from your performance obligations is recognized over time or at a point in time. Please also clarify your methods used to measure progress, if applicable, and why the methods reflect a faithful depiction of the transfer of the services. Reference ASC 606-10-50-18.

Example SEC staff comment: Disaggregated revenue disclosures

We note your disaggregated revenue disclosures by product and by geographic region. 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 for disclosing further disaggregation of revenue for other products similar to the table disclosed in Item 1, Business, and in your earnings releases furnished on Form 8-K. 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 asked registrants to further explain and sometimes provide their analysis for certain judgments and estimates made in their application of the standards. This is consistent with previous public remarks by the SEC staff that registrants need to provide clear and transparent disclosures about the significant judgments they made to apply the standard for each material revenue stream.

How we see it

Based on what we have seen, registrants appear to have been able to resolve these comments in the same manner as comments on other topics. That is, registrants have helped the staff gain a better understanding of the judgments made by management or provided additional disclosures in future filings.

The SEC staff has said it will continue to review the application of the new revenue standard and disclosures as part of its review process and will question when it appears that a registrant may not be complying with the standard.

Non-GAAP financial measures

"The SEC staff is challenging more non-GAAP measures because they involve individually tailored accounting principles.

The SEC staff continues to focus on whether non-GAAP financial measures reported by registrants comply with the Non-GAAP Financial Measures Compliance and Disclosure Interpretations (C&DIs), which it updated in May 2016. Lately, we have observed an increase in the number of comments that challenge whether a registrant has presented a non-GAAP measure that employs an individually tailored accounting principle that may be misleading.

The SEC staff has said in recent speeches that a measure of a registrant's historical or future financial performance, financial position or cash flows may involve misleading tailored accounting principles if it:

- Changes an item from an accrual to cash basis or from gross to net
- Proportionately consolidates an entity not eligible for that treatment under US GAAP
- Reflects part, but not all, of an accounting concept (e.g., current income tax expense but not deferred income tax expense)
- Renders a measure inconsistent with the economics or terms of an agreement

Example SEC staff comments: Non-GAAP disclosures that may be misleading
Eliminating amortization of acquired intangibles We note your computations of non-GAAP measures Adjusted Operating Earnings, Adjusted Net Income and Adjusted Earnings Per Share exclude acquisition-related intangible assets amortization. Please tell us how you determined the adjustments to exclude the amortization of certain acquired intangible assets do not substitute individually tailored income or expense recognition methods for those of GAAP. Refer to Question 100.04 of the Non-GAAP Financial Measures Compliance and Disclosure Interpretations.

Other examples of non-GAAP financial measures that the staff has challenged include those changing the recognition or measurement principles of the new revenue standard or proportionately consolidating equity method investees. More examples are provided in our companion publication.

How we see it

Based on our review of recent comment letters, the SEC staff's views about what is acceptable appear to be evolving. Significant judgment is required to determine whether a measure employs an individually tailored accounting principle because the criteria are general and highly subjective.

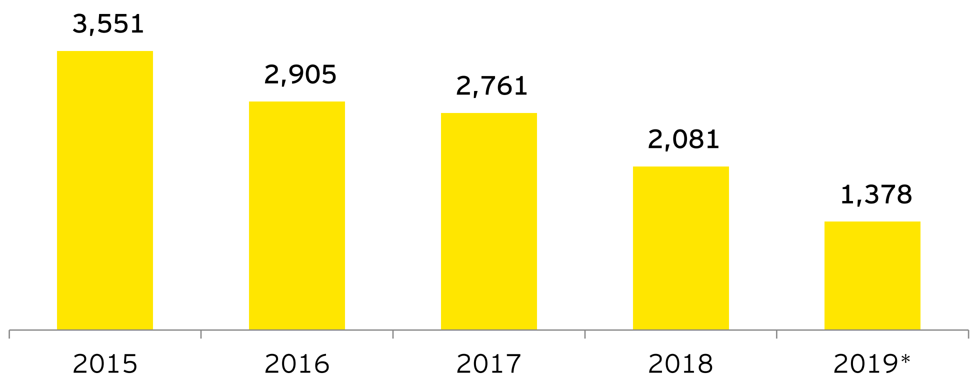
Until the SEC staff provides more clarity, registrants should consider whether they are using measures that the SEC staff has concluded are inappropriate because they involve misleading individually tailored accounting principles.

General observations

Number of SEC staff comment letters continues to decline

The volume of SEC staff comment letters in the year ended 30 June 2019 declined by approximately one-third from the previous year, continuing the trend of recent years. In the latest period, the SEC staff issued fewer than half as many comment letters as it just two years ago.

Number of SEC comment letters by year



Source: *Audit Analytics — SEC UPLOAD comment letters issues related to Forms 10-K and 10-Q for the 12-month periods ended 30 June 2018 through 30 June 2019*

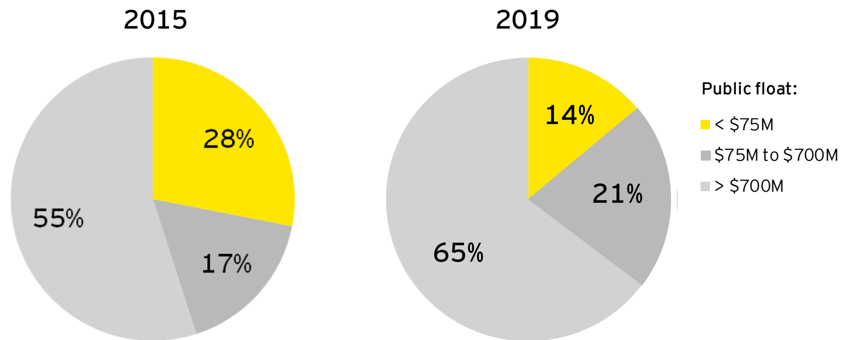
* *The SEC publicly releases comment letters no earlier than 20 business days after the completion of its review. Therefore, some letters for the 12-month period ended 30 June 2019 may not yet be publicly available.*

While a portion of the decline in the number of SEC comment letters in the last year is likely attributable to the effects of the partial government shutdown during parts of December and January, the overall number of comment letters has declined in recent years as the SEC staff has focused on reviewing large registrants and has refined its consideration of materiality before issuing comments.

The SEC staff uses 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 most of the US equity market's capitalization. More regular reviews of larger companies decrease the likelihood that there will be issues worthy of comment in every review. While the SEC staff still must review smaller companies at least once every three years, it may be more judicious in issuing comments to those companies, given their smaller market exposure.

As this chart shows, the comments issued to non-accelerated filers decreased substantially to 14% of the total in 2019 from 28% in 2015:

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 2015 and 30 June 2019.*

> The SEC staff continues to focus on the accounting topics 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*
	2019	2018	2018 and 2019
Revenue recognition	1	5	23%
Non-GAAP financial measures	2	2	35%
MD&A**	3	1	33%
Fair value measurements***	4	3	14%
Intangible assets and goodwill	5	6	10%
Income taxes	6	8	10%
State sponsors of terrorism	7	7	11%
Segment reporting	8	4	11%
Acquisitions and business combinations	9	9	7%
Signatures/exhibits/agreements	10	****	5%

* 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 2017 through 30 June 2019. 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 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 2018.

Future areas of focus

Leases

While the SEC staff has not yet issued many comments on the application of the new leases standard,[2] the comments it has issued have generally focused on the completeness of a company's disclosures, including disclosures related to transition and discount rates. The low number of comments for the year ended 30 June 2019 likely reflects the limited number of early adopters of the new leases standard. As the SEC staff reviews more annual reports that reflect adoption of the leases standard, we expect the number of comments to increase.

Phase-out of LIBOR

We expect the SEC staff to soon begin scrutinizing registrants' disclosures about the anticipated phase-out of the London Interbank Offered Rate (LIBOR), which is expected to occur in 2021. The staff of the Division of Corporation Finance said in a statement[3] that it is important for companies to keep investors informed about their progress in managing the transition to an alternative reference rate in a wide variety of commercial and financial contracts. Potential disclosures the staff cited include:

- Risks, if material, related to the transition and how they are being mitigated
- The status of company efforts to date and the significant matters pertaining to the transition that have not yet been addressed
- Material exposures to LIBOR that the company has identified but cannot yet estimate their effect

Brexit

We also expect the SEC staff to challenge whether affected registrants need to make additional disclosures in their filings to address the United Kingdom's plan to withdraw from the European Union, which is known as Brexit. SEC officials have said that disclosures about the effects of Brexit, if material, should be robust and tailored to a company's facts and circumstances, though this hasn't yet been an area of frequent comment. The United Kingdom is currently scheduled to exit the European Union on 31 October 2019.

Endnotes:

1 ASC 606, *Revenue from Contracts with Customers*.
2 ASC 842, *Leases*.
3 SEC, ***Staff Statement on LIBOR Transition,*** 12 July 2019.