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SEC Reporting Update

Highlights of trends in 2021 SEC comment letters

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What you need to know

- Non-GAAP financial measures remained in the top spot in our list of the most frequent topics in SEC staff comment letters for the year ended 30 June 2021. Management's discussion and analysis and segment reporting were second and third, respectively.
- The volume of SEC staff comment letters on periodic reports continued to decline and was down by 20% from the previous year.
- The SEC staff continued to issue comment letters addressing registrants' COVID-19 disclosures in management's discussion and analysis, business descriptions, and risk factors in addition to disclosures about fair value measurements and other topics, including the use of non-GAAP financial measures.
- As part of its increased focus on disclosures related to ESG matters, the SEC staff has started issuing comments on climate-related disclosures, including considerations of the Commission's 2010 guidance.
- Companies planning to go public through an initial public offering or merger with a special purpose acquisition company should consider the topics of frequent comment when preparing their initial registration statements and subsequent filings.

Overview

The topics the Securities and Exchange Commission (SEC or Commission) staff addressed most frequently in comment letters for the year ended 30 June 2021 were non-GAAP financial measures, management's discussion and analysis (MD&A), and segment reporting.

Building a better working world

In our review of SEC staff comment letters on periodic reports, we also found that the volume of SEC staff comment letters continued to decline and was down 20% from the previous year.

During the year, the SEC staff issued a number of comments addressing disclosures about the COVID-19 pandemic. They focused on the specificity of a company's disclosures of risk factors and the effects of the pandemic in MD&A, fair value measurements and non-GAAP financial measures.

This publication is intended to provide you with insights on the types of issues that the SEC staff has raised questions about throughout the year to help you prepare for an SEC staff comment. It is not intended to drive changes to your accounting or disclosures unless you determine that changes are necessary to comply with the accounting or disclosure requirements.

Companies receiving comment letters from the SEC staff should view the process as an opportunity to educate the staff about their facts and how they arrived at the conclusions leading to their disclosure rather than an indication that revisions are necessary. This should also include the company's consideration of materiality. This publication also includes tips on how to navigate the comment-letter process.

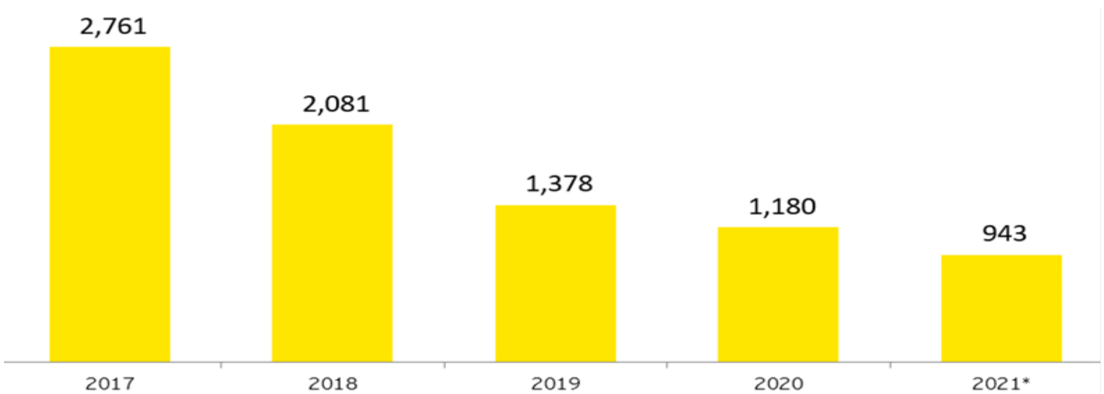
"The SEC staff continues to use its risk-based approach of concentrating on larger issuers and reviewing their filings more frequently.

Trends in 2021 SEC staff comment letters

Number of SEC staff comment letters declined again

The volume of SEC staff comment letters on periodic reports in the year ended 30 June 2021 declined approximately 20% from the previous year, continuing the downward trend of recent years.

Number of SEC comment letters by year



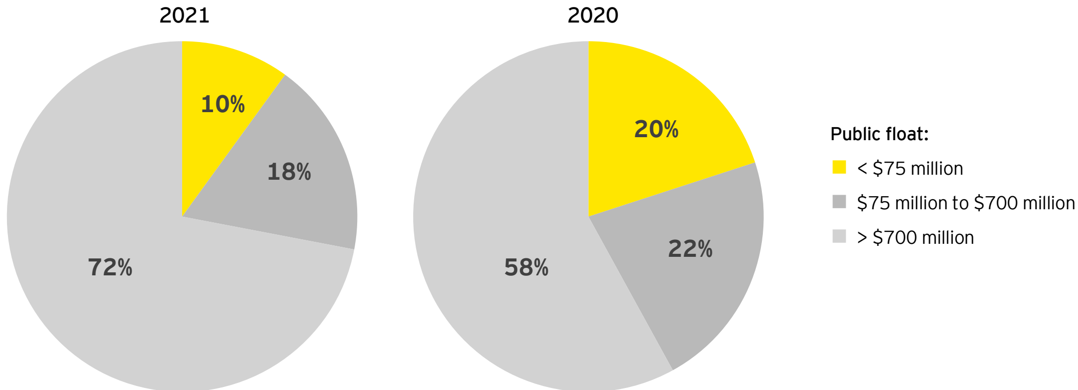
Source: Audit Analytics — SEC UPLOAD of comment letters related to Forms 10-K and 10-Q that were publicly available during the 12-month periods ended on 30 June each year.

* The SEC publicly releases comment letters no earlier than 20 business days after the completion of its reviews, meaning the SEC staff may have issued some letters before 30 June but those letters may not have been publicly available as of the date of our analysis.

The SEC staff continues to use its risk-based approach, which involves concentrating on larger issuers and reviewing their filings more frequently. We believe this approach has contributed to an overall improvement in disclosure, which has allowed the staff to issue fewer comments over time.

The trend was even more pronounced in the most recent year, with 72% of comment letters going to companies with public floats of more than $700 million, up from 58% the previous year.

Size of registrants receiving comment letters on Forms 10-K and 10-Q filings



Source: Audit Analytics — SEC UPLOAD comment letters issued related to Forms 10-K and 10-Q for the 12-month periods ended 30 June 2021 and 30 June 2020.

Larger registrants represent a relatively small percentage of the total number of registrants, but they account for most of the US equity market's capitalization. While the SEC staff still must review the filings of smaller registrants at least once every three years, it tends to have a relatively high threshold for issuing comments to those registrants, given the smaller amount of investor dollars at risk.

Most frequent comment areas

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.

	Ranking 12 months ended 30 June		Comments as a % of total registrants that received comment letters*
Comment area	2021	2020	2020 and 2021
Non-GAAP financial measures	1	1	37%
Management's discussion and analysis (MD&A)**	2	2	37%
Segment reporting	3	4	17%
Revenue recognition	4	3	19%
Fair value measurements***	5	5	8%
Signatures/exhibits/agreements	6	10	6%
Goodwill and intangible assets	7	6	7%
Contingencies	8	7	5%
Inventory and cost of sales	9	8	5%
Income taxes	10	9	4%

* These rankings are based on topics assigned by research firm Audit Analytics for SEC comment letters issued to registrants with a market cap of $75 million or more about Forms 10-K and 10-Q from 1 July 2019 through 30 June 2021. 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 (68%), (2) critical accounting policies and estimates (15%), (3) liquidity matters (14%) and (4) business overview (3%).

*** The majority of the SEC staff's comments on fair value measurements are related to goodwill impairment analyses, which are discussed in the *Goodwill and intangible assets* section of this publication.

Non-GAAP measures and MD&A drew the most scrutiny from the SEC staff, followed by segment reporting. The frequency of comments on revenue recognition peaked when registrants were adopting Accounting Standards Codification (ASC) 606, *Revenue from Contracts with Customers*, and has continued to decline.

COVID-19 observations

In the early days of the COVID-19 pandemic, SEC officials issued a series of statements and the SEC's Division of Corporation Finance staff issued more detailed guidance to help companies meet their disclosure obligations and consider the impact of the pandemic in their periodic reports.[1] These statements and guidance allowed companies to consider the SEC staff's expectations before providing their disclosures to investors.

Over the last year, the SEC staff issued comments on registrants' accounting and disclosures related to COVID-19 and non-GAAP financial measures that adjust for COVID-19, including information about specific risk factors, clarity of MD&A disclosure of the effects of the pandemic and the impact of government assistance.

Comments on accounting and disclosures related to COVID-19

The statements and guidance issued by the SEC staff made it clear that COVID-19 could affect all major sections of a company's periodic reports. The SEC staff has asked some companies to provide more information about specific risk factors when the disclosures have been limited to general statements about uncertainties created by the pandemic. The SEC staff has asked for details that are tailored to a company's facts and circumstances.

Example SEC staff comment: Risk factor disclosure

We note that the majority of your sales are in domestic markets and your most significant customer operates primarily in [Location X]. Given the continued rise in COVID-19 cases throughout the United States, including [Location X], please ensure that your MD&A disclosures in your upcoming Form 10-Q for the period ended June 30, 2020, address the matters described in CF Disclosure Guidance: Topic 9A. Please similarly revise your risk factor and financial statement disclosures as appropriate. Disclosures should address, but not be limited to, the following:

- Known or expected impacts upon your backlog and peak selling season
- Any potential supply chain disruptions (particularly with respect to raw materials needed for assembly)
- Any material changes to your manufacturing process (including measures taken to protect workers in your manufacturing facilities)
- Any known or expected adjustments needed to ensure sufficient access to capital (e.g., plans to increase borrowings, reduce dividend payments or curtail capital expenditures)
- Known or expected impacts on the timing of the plant expansion at [Location X]

How we see it

Well-crafted risk factor disclosures, including any related to the pandemic, typically provide an exhaustive list of the material adverse effects that a company might experience. The SEC staff has used these disclosures as a road map to determine whether disclosure is lacking in other areas of a filing, particularly MD&A, and has asked for more COVID-19 disclosure.

“

Registrants must comply with the SEC’s rules and guidance when reporting non-GAAP measures that reflect adjustments for COVID-19.

The effects of the pandemic on many companies’ results have been significant. Those companies typically added MD&A disclosure to explain those effects. However, the SEC staff has issued comments to companies even when disclosure specific to the pandemic has been included in MD&A. These comments have focused on making sure that companies are explaining their results in a way that is clear and understandable to investors.

Example SEC staff comment: MD&A disclosure — historical results
Your discussion of changes in international wholesale segment sales attributes the decrease in sales to pandemic-related store closures, which does not appear to provide enough context for the changes in revenue during the periods presented. Similar to your discussion of revenue changes in domestic wholesale sales, please revise to disclose sales volume, changes in average selling price and/or other underlying drivers for the change in international wholesale segment sales.

When operating results and market capitalizations decline significantly, as they did for many companies during the pandemic, the risk of impairment of long-lived assets increases. As discussed further in the *Goodwill and intangible assets* section, the SEC staff often asks companies to provide additional MD&A disclosure to address this risk when it exists.

Non-GAAP financial measures that adjust for COVID-19

The SEC staff issued several comments on non-GAAP measures adjusted for effects of the COVID-19 pandemic, and those comments were mainly to request more information about the nature of the non-GAAP adjustments and the method used to calculate them.

Companies should be aware that Item 10(e) of Regulation S-K, Regulation G and the SEC staff’s guidance on non-GAAP measures continue to apply to adjustments related to the effects of COVID-19.

Registrants that want to adjust for the effects of COVID-19 should limit adjustments in their non-GAAP measures to charges incurred or gains recognized that clearly relate to COVID-19 and are incremental to, and separable from, normal operations. We believe that adjustments for charges or gains related to the following activities may be acceptable if the charges or gains are attributable to COVID-19 and are incremental to and separable from normal operations:

- Temporarily paying a premium to compensate employees for performing their normal duties at increased personal risk (e.g., hazard pay)
- Cleaning and disinfecting facilities more thoroughly and/or more frequently
- Terminating contracts or complying with contractual provisions invoked directly due to the events of the pandemic (e.g., contract termination fees or penalties)
- Insurance recoveries

Companies that make such adjustments should continue to evaluate whether they are incremental to normal operations. For example, if higher cleaning expenses become part of a company’s normal operations and are expected to continue after the pandemic, making that adjustment would no longer be appropriate.

The SEC staff provided the following examples of adjustments that would not be appropriate:

- Estimated lost revenue
- Paying idled employees
- Expenses related to temporarily idled facilities, including rent

Example SEC staff comment: Non-GAAP adjustments
Your non-GAAP results include adjustments for occupancy charges at stores temporarily closed and payroll and benefits for store employees during the period stores were closed. It appears that these are normal, recurring cash operating expenses. Please tell us how you considered the guidance in Question 100.01 of the Non-GAAP Financial Measures Compliance and Disclosure Interpretations. In addition, since inventory provisions are typically recurring costs that are based on a variety of factors, tell us how you considered the guidance in Question 100.04 of the Non-GAAP Financial Measures Compliance and Disclosure Interpretations in adjusting for an inventory provision due to COVID-19. Also, explain in detail how the amount of the inventory provision directly related to COVID-19 was objectively determinable and why it could not be partially attributed to other market factors and conditions.

A registrant that is considering making adjustments for charges and gains attributable to COVID-19 should be mindful of the SEC staff's guidance that says a non-GAAP measure can be misleading if it excludes nonrecurring charges but does not exclude nonrecurring gains. See our Technical Line, ***How to appropriately use non-GAAP measures to discuss the effects of COVID-19,*** for further discussion.

How we see it

While some companies used new non-GAAP measures to discuss the effects of the pandemic, we did not observe widespread use among registrants. Most registrants discussed and quantified (where possible) the impacts of the pandemic separately.

CARES Act

The Coronavirus Aid, Relief, and Economic Security (CARES) Act, which was enacted on 27 March 2020 and provided an estimated $2.2 trillion to fight the COVID-19 pandemic and stimulate the US economy, will continue to have accounting and financial reporting consequences for affected companies. For example, certain government grants and loans provided by the CARES Act came with conditions that will affect various areas of financial reporting, including compensation and disclosures.

The SEC staff has provided guidance for companies that have received government assistance through the CARES Act and for companies facing substantial doubt about their ability to continue as a going concern. The SEC staff has asked some companies to provide more information about the impact of government assistance received, including loans through the US Small Business Administration's Paycheck Protection Program authorized as part of the CARES Act.

Example SEC staff comment: Impact of government assistance
We note the CARES Act provides a mechanism to recover your labor costs where your employees are ready and able to work but unable to access required facilities due to COVID-19. If you received any assistance under the CARES Act (including, but not limited to, Section 3610 thereunder to keep your employees and subcontractors in a ready state), please quantify and disclose the short- and long-term impact of that assistance on your financial condition, results of operations, liquidity and capital resources. Refer to CF Disclosure Guidance: Topic No. 9A.

IPOs and SPAC mergers

Despite the pandemic and macroeconomic uncertainties, investor interest in the initial public offering (IPO) market was strong in 2020 and the first half of 2021, when the number of deals and total proceeds raised reached their highest levels in more than 20 years. Activity in the special purpose acquisition company (SPAC) market also reached an all-time high. Merging with a SPAC offers private companies a way to go public without conducting a traditional IPO.

The SEC staff comments on registration statements often focus on many of the same accounting and disclosure topics identified in the top 10 most frequent comment areas, which are further discussed elsewhere in this publication. This section addresses SEC staff comments on certain topics that relate to IPO and SPAC transactions.

Pro forma financial information

Pro forma financial information may be required in an IPO registration statement for various reasons, including showing the effects of significant consummated or probable acquisitions or dispositions. Pro forma financial information may also be required if reorganizations, unusual asset exchanges, debt restructurings, debt refinancings or other changes in capitalization (e.g., conversion of debt or redeemable preferred stock into common stock) occur at the effective date or the close of an offering, including an IPO. Pro forma adjustments often require significant judgment and are a focus area for the SEC staff.

In May 2020, the SEC amended its requirements for the form and content of pro forma information about significant business acquisitions and disposals. The SEC staff has commented when the pro forma presentation does not comply with the requirements under the amended rules.

Example SEC staff comment: Amended pro forma rules
It appears the unaudited pro forma condensed combined financial information has been prepared under the legacy rules of Article 11 of Regulation S-X. Please be advised the amended rules to Article 11 of Regulation S-X became effective on January 1, 2021, for calendar year-end registrants. In this regard, please revise your pro forma presentation to comply with the requirements under the amended rules.

Please refer to our SEC Financial Reporting Series publication, ***Pro forma financial information: a guide for applying amended Article 11 of Regulation S-X***, for more information on the preparation of pro forma financial information.

The SEC staff also has requested registrants to provide detailed discussion of the accounting treatment for transactions included in the pro forma information and to separately describe and present each material transaction.

Example SEC staff comment: Pro forma information
Please expand your disclosure to include the accounting treatment of the business combination such that it will be accounted for as a reverse recapitalization in accordance with US GAAP. Your revised disclosure should be similar to the level of detail provided on page [X] with respect to the business combination. In addition to the reverse recapitalization transaction, we note your pro forma balance sheet and income statement also give effect to financing transactions from (1) the sale of [XX] million shares of common stock for an aggregate purchase price of $[XXX] million to the PIPE Investors, (2) the sale of [X] million Units to Investor A for $[X] million and (3) the partial repayment of debt in the amount of $[XXX] million from the PIPE proceeds. These financing transactions appear to be separate material transactions from the business combination. If so, please revise your introductory paragraph to describe each item separately and revise your pro forma balance sheet and income statement to show them separate from the reverse acquisition in accordance with Rule 11-01(a)(8) of Regulation S-X. If you do not believe the guidance applies, please explain why. Refer to the amended rules under Article 11.

A registrant may need more than one pro forma presentation if a proposed transaction may have significantly different results. The additional results may be equally important, depending on the facts and circumstances. For example, more than one pro forma presentation may be necessary to reflect different assumptions about the number of securities sold in a minimum/maximum transaction (e.g., the transaction will not close unless a minimum number of securities is sold), a range of possible redemption scenarios in transactions involving the acquisition of a target company by a SPAC or to reflect variability in the purchase price for a proposed acquisition.

Example SEC staff comment: Multiple pro forma presentations
Please revise the pro forma balance sheet to present first a pro forma balance sheet assuming no redemptions and a pro forma balance sheet assuming maximum redemptions, before presenting the pro forma combined balance sheets. In separate adjustment columns following the historical balance sheet, present pro forma adjustments to give effect to (1) the liquidation and reclassification of $[XXX] million of investments held in the trust account to cash, (2) the payment of $[X] million of deferred underwriters' fees and (3) the reclassification of Class A common stock subject to possible redemption to permanent equity, assuming no redemptions.

Because a SPAC's public shareholders have the right to redeem their shares for a pro rata portion of the proceeds held in the trust account if they do not wish to invest in the proposed target(s), the pro forma financial information may need to consider both (1) a minimum redemption scenario, in which no shares are redeemed by public shareholders, and (2) a maximum redemption scenario. In certain situations, exercising a backstop financing arrangement could change the accounting treatment (i.e., forward merger or reverse recapitalization) of the transaction. If that's the case, a SPAC would have to account for the transaction differently in the minimum and maximum redemption scenarios, and both treatments would need to be reflected in the pro forma financial information.

Risk factors

Item 503(c) of Regulation S-K requires a registrant to disclose significant risks it faces and how it is affected by each of them. Risk factors should be specific to the registrant's facts and circumstances and should not be general risks that could apply to any registrant. The SEC staff has questioned risk factor disclosures that are not appropriately tailored to an individual registrant. 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.

We recently have observed the SEC staff issuing comment letters related to the considerations highlighted in CF Disclosure Guidance: Topic No. 11, *Special Purpose Acquisition Companies*. These comments address the nature of the economic interests of the SPAC's sponsors, directors, officers and affiliates; potential conflicts of interest; and other SPAC-specific risk factors.

Example SEC staff comment: SPAC merger risk factor disclosure
Please disclose the material risks to unaffiliated investors presented by taking the company public through a merger rather than an underwritten offering. These risks could include the absence of due diligence conducted by an underwriter that would be subject to liability for any material misstatements or omissions in a registration statement.

Projections

SPACs often include projections for the target company in these filings to facilitate shareholder review and approval of the transaction. The SEC staff has requested that companies revise disclosures to describe material assumptions and limitations underlying the projections with greater specificity and to quantify such information where practicable.

Example SEC staff comment: Assumptions used in projections
We note that the projections of revenue in 2021 reflect an increase of over 180% from 2020 levels. Given that the projections do not appear in line with historic operating trends, please clarify if the projections reflect anticipated changes or trends. Please disclose the reasonable basis for projecting significant increases in revenue, including the specific assumptions that management used in calculating the projections. Also disclose the specific risks relating to the assumptions and projections.

Projections, if included, should be based on reasonable assumptions and should represent a balanced view. They should also be identified as forward-looking statements and accompanied by meaningful cautionary statements describing factors that could cause actual results to differ materially from the projection.[2]

Valuation of share-based payments

The SEC staff continues to challenge the valuation of share-based payment awards issued in the period before an IPO that are significantly lower than the estimated IPO price. Recently, the staff has also been challenging the valuation of awards issued before a SPAC merger transaction that are significantly lower than the fair value implied by the merger transaction.

Companies should be aware of the American Institute of Certified Public Accountants' Accounting and Valuation Guide, *Valuation of Privately-Held-Company Equity Securities Issued as Compensation,* which provides a framework and describes leading practices for valuing private company securities. Companies contemplating IPOs should obtain contemporaneous valuations from independent valuation specialists to support the fair value of securities issued as compensation in the period leading up to an IPO.

Example SEC staff comment: Valuation of share-based payment awards
Please explain to us how you determined the fair value of the common stock underlying your equity issuances and the reasons for any differences between the recent valuations of your common stock leading up to the initial public offering and the estimated offering price or range.

To respond to these comments, companies should be prepared to discuss in detail the change in the estimated fair value of the underlying security between the share-based payment award grant date and the IPO date by considering changes in valuation assumptions and other market changes that support the difference in fair value.

Prospectus summary

Item 503 of Regulation S-K requires registrants to provide a summary of the information in the registration statement in cases where the length and complexity of the document makes a summary useful. The prospectus summary should provide a brief overview of the key aspects of the offering. Registrants are encouraged to carefully consider and identify the most significant aspects of the offering and highlight those aspects in clear, plain language. The SEC staff frequently issues comments asking registrants to properly balance the disclosures between positive and negative information.

Example SEC staff comment: SPAC prospectus summary
Please revise your Prospectus Summary to discuss the potential conflicts of interest arising from the difference in price per share paid for founder shares and public shares and the fact that founder shares and warrants will become worthless if you do not enter into a business combination. Please also disclose in quantitative and qualitative terms how economic incentives could result in substantial misalignment of interests where an initial business combination does occur. For example, since your sponsor acquired an approximately 20% stake at a purchase price of $0.00X per share and the offering is for $10.00 per unit, the sponsor could make a substantial profit after the initial business combination even if public investors experience substantial losses.

Use of proceeds

Item 504 of Regulation S-K requires registrants to describe the planned uses and amounts of offering proceeds. These disclosures should allow users to understand the major areas for which the funds will be used, including whether any proceeds will be used to discharge debts, to complete an acquisition or for working capital. The SEC staff may request that a company provide additional details about how it will use proceeds from the offering.

Example SEC staff comment: Use of proceeds
Because you will use a portion of the proceeds to repay debt, please disclose the interest rate and maturity of such indebtedness. Further, because a portion of these Notes appears to have been issued within one year, please describe the use of the proceeds of such indebtedness other than short-term borrowings used for working capital. See Instruction 4 to Item 504 of Regulation S-K.

SEC review of IPO and SPAC transactions

The SEC staff review process begins when the SEC receives the first submission or filing. Companies generally can expect to receive the first round of SEC comments within one month of submitting a registration statement. While all comments must be resolved prior to the IPO registration statement being declared effective, most companies seek to have significant comments resolved prior to launching a road show.

Because SPAC mergers often result in a private operating company becoming a publicly traded entity, the SEC staff will generally review proxy statements and joint statements related to such transactions. The SEC staff has a target of issuing comments on such filings within 30 days and subsequent rounds of comments on amendments more quickly than that (generally 10 days). SPACs can expect to receive a few rounds of SEC staff comments before the definitive proxy can be filed and distributed or a joint statement can be declared effective and distributed. Most SPACs complete the SEC filing review and comment process for their proxy statements or joint statements over a period of several months, similar to the review period for traditional IPO registration statements. For more information on the SEC staff review of SPAC mergers, see our Technical Line, ***Navigating the requirements for merging with a special purpose acquisition company***.

Responding to a comment letter

General

The SEC staff views the comment process as a dialogue with a registrant about its disclosures, and the comments should not be interpreted to mean that the staff has concluded that the disclosures must change. In many cases, comments are resolved once the SEC staff has gained a full understanding of a registrant's facts and circumstances and has obtained sufficient insight into the judgments made by management that led to the disclosures. A substantial majority of reviews are closed after one comment letter, and reviews rarely extend beyond two letters.

Drafting the response letter

A registrant generally responds to an SEC comment letter by sending a letter back to the SEC staff. When responding to the SEC staff comment letters:

- Registrants should assume that the SEC staff has not yet concluded on a matter and merely needs more information, unless the staff clearly indicates in its comment that this is not the case.
- Registrants should focus their responses on the question(s) asked by the SEC staff and cite authoritative literature and related guidance wherever possible.
- Registrants should address their unique facts and circumstances and provide insight into any judgments they made in applying the relevant guidance. While it may be helpful to consider responses from other registrants on similar topics, registrants should be cautious when leveraging those responses because there may be differences in facts that are not readily apparent.
- Registrants should file all response letters on EDGAR, redacting any information for which they are seeking confidential treatment.
- Registrants that plan to revise their disclosure as a result of a comment from the SEC staff should indicate in their response where these revisions will be made. It can also be helpful for the registrant to provide proposed language in its response letter, but registrants should make it clear that facts and circumstances may change in a way that could require different disclosure.
- Registrants should seek the input of all appropriate internal personnel and professional advisers (such as legal counsel and independent auditors) early in the process to make sure their responses are complete and accurate. Waiting for another round of comments before involving the necessary resources may delay or hinder a successful resolution.

Documentation

To facilitate responses to SEC staff comment letters, registrants should maintain contemporaneous documentation of significant accounting and disclosure decisions. Contemporaneous documentation is more persuasive than a retrospective defense prepared after the receipt of a comment letter and facilitates a more comprehensive and timely response.

Materiality

Registrants should also consider materiality when responding to an SEC staff comment letter. A registrant should address materiality in its response letter when asked by the SEC staff why a particular disclosure does not appear in its filing or when responding to questions about the accounting for an item the registrant believes is immaterial. The SEC staff has stated that it is important for registrants to do so when materiality was a factor in an accounting or disclosure conclusion addressed in a comment letter. In these cases, registrants should provide a robust explanation of the qualitative and quantitative factors it considered as part of its materiality analysis.

Reconsideration

The SEC staff and the registrant may ultimately disagree about an accounting or disclosure matter. A registrant may seek reconsideration of a comment by other SEC staff, including those in the Division of Corporation Finance's Office of the Chief Accountant (CF-OCA). SEC 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 more senior SEC staff reconsider a comment or reconsider a staff member's view of the registrant's response at any point in the filing-review process. The SEC does not have a formal protocol for registrants to follow when seeking reconsideration; a request for reconsideration may be made orally or in writing. Registrants also may ask the SEC's Office of the Chief Accountant (OCA), which is distinct from CF-OCA, to reconsider an accounting conclusion of the SEC staff at any stage in the process.

Generally, OCA addresses questions about the application of accounting principles while the CF-OCA resolves matters concerning the age, form and content of financial statements required to be included in a filing. Even before a registrant requests reconsideration, CF-OCA and OCA may have already been consulted informally. A registrant should initiate a reconsideration by OCA by informing the staff that issued the comment of its intention to request reconsideration. If all of the relevant information is contained in comment letter responses from the registrant, a registrant does not need to make a submission directly to OCA, although a separate submission may expedite the process.

Timing

Comment letters from the SEC 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 SEC staff, which generally grants extensions that will enhance the quality of the response letter. A registrant also may consider contacting the SEC staff if it needs clarification about a comment or informal feedback regarding its approach to responding.

Non-GAAP measures

The SEC staff continues to focus on whether non-GAAP financial measures reported by registrants comply with its compliance and disclosure interpretations (C&DIs) on this topic, including whether certain performance indicators should have been identified as non-GAAP measures and whether identified non-GAAP measures are presented with the most directly comparable GAAP financial measure at the appropriate prominence level.

In addition, the SEC staff has continued to challenge whether a registrant was presenting a non-GAAP measure that employs an individually tailored accounting principle that may be misleading. For example, the SEC staff recently has challenged non-GAAP measures with the word "revenue" in the title, as discussed below.

Most of the SEC staff comments have focused on registrants' use of non-GAAP measures in earnings releases and SEC filings. However, the SEC staff also reviews non-GAAP measures registrants use to communicate elsewhere (e.g., on their websites, in investor presentations).

Compliance with Item 10(e) of Regulation S-K

As defined in Item 10(e) of Regulation S-K, a non-GAAP financial measure is a numerical measure of a registrant's historical or future financial performance, financial position or cash flows that either:

- Excludes amounts, or is subject to adjustments that have the effect of excluding amounts, that are included in the most directly comparable measure calculated and presented in accordance with US GAAP in the statement of comprehensive income, balance sheet or statement of cash flows (or equivalent statements) of the issuer
- Includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the most directly comparable US GAAP measure so calculated and presented

The SEC staff often requests additional information and explanation from a registrant when a measure is not identified as a non-GAAP measure but may meet the definition in Item 10(e).

Example SEC staff comment: Definition of a non-GAAP measure
Net loss as adjusted for non-cash and non-operating items appears to represent a non-GAAP measure. Please either remove this subtotal or provide the disclosures required by Item 10(e) of Regulation S-K.

Item 10(e)(1)(i) of Regulation S-K provides disclosure requirements that apply when a registrant presents non-GAAP financial measures in SEC filings and earnings releases furnished on Form 8-K. Among other things, registrants presenting non-GAAP financial measures must:

- Present the most directly comparable financial measure calculated in accordance with GAAP with equal or greater prominence
- Provide a reconciliation of the differences between the non-GAAP measure and its most directly comparable GAAP measure
- Disclose the reasons why management believes that the non-GAAP measure provides useful information to investors, as well as any additional purposes for which the registrant's management uses the non-GAAP measure

"The SEC staff continues to challenge non-GAAP measures that employ individually tailored accounting principles.

The SEC staff believes that to comply with the requirement to present the comparable GAAP measure with equal or greater prominence, a registrant needs to present the GAAP measure before the related non-GAAP measure. For this reason, GAAP measures must precede the non-GAAP measures in the required reconciliations. The SEC staff has also objected to registrants presenting a full non-GAAP income statement as a form of reconciliation because this makes the non-GAAP information more prominent.

Example SEC staff comment: Prominence of non-GAAP measures
Reference is made to your bold disclosure of adjusted operating income on page 1, which precedes the most directly comparable GAAP measure. Please present the most directly comparable GAAP measure with equal or greater prominence in future filings. Refer to Item 10(e)(1)(i)(A) of Regulation S-K and Question 102.10 of the Non-GAAP Financial Measures C&DIs.

The SEC staff also has asked registrants to clarify and expand their disclosures to discuss why a particular measure is useful to investors and how management uses it. Often, the disclosures that the SEC staff asks about are boilerplate or too general to help readers understand how they should use a particular measure.

If a registrant cannot explain why a measure is useful to investors, or if the SEC staff believes the presentation could be misleading, the SEC staff has asked registrants to expand the disclosure or remove the non-GAAP measure.

Example SEC staff comment: Usefulness of a non-GAAP measure
We refer to your presentation of Gross Sales throughout your filing and note it is not a measure recognized under GAAP. Please help us understand: ‣ What Gross Sales represents. For example, tell us if this amount represents the amount invoiced to your customers, the full retail price of your products or some other value ‣ How you considered Item 10(e) of Regulation S-K and Regulation G ‣ How you analyze trends in Gross Sales, aside from the changes based on overall selling price versus changes in units shipped ‣ How Gross Sales is useful to investors given that gross sales may not be realized in the form of cash receipts due to Sales Allowances

Registrants must also reconcile forward-looking non-GAAP measures if the forward-looking GAAP measure is reasonably available. If a comparable GAAP measure isn't available, the SEC staff expects registrants to disclose why the reconciliation is not presented.

The SEC staff has also objected to registrants presenting reconciliation adjustments net of tax. The effect of income taxes on the non-GAAP reconciliation should be shown as a separate adjustment and clearly explained.

Compliance with C&DIs

Individually tailored accounting principles

The C&DIs provide guidance on uses of non-GAAP measures that the SEC staff believes could be misleading. For example, the staff said in the C&DIs that a non-GAAP measure may be considered misleading if it uses an individually tailored recognition or measurement principle or excludes normal, recurring cash operating expenses. In recent years, the SEC staff has broadened its approach and challenged other ways registrants modify GAAP recognition and measurement principles to calculate non-GAAP measures.

The SEC staff has focused on companies using non-GAAP measures to present financial results prepared using accounting principles that have been superseded. While companies may contemplate using non-GAAP measures to make it easier for investors to compare their current results with those for prior periods when a new standard has been adopted without full retrospective application, the SEC staff believes these measures are inappropriate because they are considered to have been prepared using individually tailored accounting principles that cause them to be misleading.

For example, the SEC staff has said that it is not appropriate for companies that adopt ASC 326, *Financial Instruments — Credit Losses*, to present a non-GAAP measure that excludes the effect of the new standard, including any measures that exclude all or part of a company's provision for credit losses.

Significant judgment is required to determine whether a measure of a registrant's historical or future financial performance, financial position or cash flows may involve tailored accounting principles.

Examples of measures that the SEC staff has objected to include those that:

- Adjust fair value of assets purchased and/or liabilities assumed recorded in purchase accounting
- Normalize effective tax rates
- Eliminate the amortization of only a portion of acquired intangibles
- Accelerate the recognition of deferred revenue or add back lost revenue
- Change an item from accrual to cash basis or from gross to net
- Deconsolidate one or more consolidated subsidiaries

Example SEC staff comment: Individually tailored accounting principle
Your adjustments for internal use software and deferred costs remove the amortization and add back amounts capitalized in the period, which appears to convert these expenses to a cash basis. Please tell us how you considered whether such adjustments create a tailored accounting principle. Refer to Question 100.04 of the Non-GAAP C&DIs.

How we see it

There are no established criteria for identifying an individually tailored accounting principle. Until the SEC staff provides more clarity, registrants should monitor SEC staff comments for objections to non-GAAP measures to determine whether they should make any adjustments to their own measures.

Over the last year, the SEC staff emphasized the importance to investors of revenue determined in accordance with US GAAP and said more companies are inappropriately presenting non-GAAP measures with the word "revenue" in the title. For example, presenting a measure entitled "gross revenue" before discounts or other incentives that reduce revenue under US GAAP would not be appropriate.

However, the staff said a registrant could present such a measure and call it "billings" if it is consistent with amounts invoiced to customers. In that case, the non-GAAP rules wouldn't apply because the metric would be considered a key performance indicator.

The staff also said some companies have presented a "net revenue" measure calculated by subtracting a portion of the cost of revenue to arrive at a tailored measure of gross margin. A registrant that presents such a measure should make it clear that it is a margin calculation and should not use the term "revenue" in the title. The registrant should also reconcile the measure to gross margin as defined in US GAAP. If a registrant does not present gross margin in its financial statements, it must calculate and disclose it to meet the requirement to reconcile non-GAAP measures with GAAP measures.

Exclusion of normal, recurring cash operating expenses

In the C&DIs, the SEC staff said that non-GAAP performance measures could be considered misleading if they exclude normal, recurring cash operating expenses necessary to operate the registrant's business. The SEC staff has challenged registrants that exclude recurring charges (e.g., costs to be a public company, frequent restructuring costs).

Example SEC staff comment: Exclusion of normal, recurring cash operating expenses
We note you present EBITDAR and Adjusted EBITDAR as non-GAAP measures used by management as key measures of performance and liquidity. We also note these measures exclude equipment rent expense, which appears to be a normal, recurring cash operating expense necessary to operate your business. Please tell us how you considered question 100.01 of the Non-GAAP C&DI when presenting these measures.

Management's discussion and analysis

The discussion below reflects the SEC staff comments with respect to registrants' application of the legacy MD&A requirements, not the amendments[3] to Regulation S-K that eliminate certain disclosure requirements and revise others and must be applied for a registrant's first fiscal year ending on or after 9 August 2021.

To date, we have not seen substantive changes in MD&A disclosures prepared by companies that have voluntarily complied with the amendments before the mandatory compliance date, and we expect registrants' MD&A disclosures for the period covered by our analysis to generally reflect the substance of the SEC's amendments.

How we see it

We may see more comments on topics addressed in the amendments, and registrants should carefully evaluate how the changes may affect their disclosures. We note that the SEC staff has frequently commented on certain of these topics in the past (e.g., the requirement that registrants provide a narrative discussion of the underlying reasons for material changes in financial statement line items in both quantitative and qualitative terms). We also believe that the incorporation in Regulation S-K of what was previously interpretive guidance on disclosures about critical accounting estimates could result in more comments on these disclosures and whether a sensitivity analysis is needed.

Results of operations

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 affected their earnings or is reasonably likely to have a material effect on future earnings. In addition to commenting on the analysis of changes in revenue, the SEC staff has been commenting on significant components of expenses and provisions.

The SEC staff also focuses on performance metrics, including whether registrants have disclosed key metrics used by management that would be material to investors and how those metrics correlate to material changes in the results of operations.

> "The SEC staff often requests that registrants explain the results of their operations with greater specificity.

Legacy 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 provide a more detailed discussion about their results of operations, including requesting that they:

- 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
- Describe any unusual or infrequent events or transactions, or any significant economic changes, that materially affected income from continuing operations, as well as the extent to which income was affected, including events that have been disclosed in the press but not disclosed in an SEC filing
- Provide insight into significant components of revenue or expense necessary to understand the results of operations (such as components of cost of sales)
- Describe any known trends or uncertainties that have had or are reasonably likely to have a material effect on sales, revenue or income from continuing operations (such as uncertainties arising from tariffs imposed on imports from foreign countries)
- Discuss reportable segment information needed to understand their results of operations or discuss results at a more disaggregated level (e.g., product line)

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
Where a material change is attributed to two or more factors, including any offsetting factors, the contribution of each identified factor should be described in quantified terms. For example, you disclose revenue growth is primarily attributable to contributions from new service centers, increased sales of advisory services, service fee increase and acquisitions, but do not quantify these factors. Please consider quantifying the factors in tabular form with the remaining written narrative focused on analyzing the reasons for such changes. In addition, please avoid vague terms such as "primarily" or "partially offset." Refer to Item 303(a)(3)(iii) of Regulation S-K and Section III.D of SEC Release No. 33-6835.

The SEC staff has also requested that companies provide forward-looking information about known trends and uncertainties. Disclosure is required for trends and uncertainties that are reasonably likely to have a material effect on revenues or income from continuing operations. In evaluating this requirement, 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 trend or uncertainty will occur, and it must disclose that item in MD&A, unless it is not reasonably likely to have a material effect.

When material effects on results of operations are attributed to a decrease in headcount or other restructuring activities, the SEC staff may ask registrants to discuss their expectations about these activities. When registrants discuss changes in economic conditions, laws, regulations or foreign exchange rates, the SEC staff may ask about the expected effects of these items on revenues, income and liquidity in future periods.

Example SEC staff comment: Results of operations — known trends and uncertainties
We note your disclosures regarding the tariff on imports that could adversely affect your costs, supply or have other material adverse impacts on your business. When considering the requirements of Item 303(a)(3)(ii) of Regulation S-K, please tell us how you concluded you did not need to describe trends or uncertainties related to these tariffs that have had or that you reasonably expect will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations, or any material changes in the relationship between costs and revenues.

Significant components of expense

The SEC staff has asked registrants to expand their discussions about significant components of operating expenses, such as costs of sales. In their segment discussions, registrants often describe only changes in revenue and segment profit or loss and do not directly explain the 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 results. The SEC staff believes this information helps investors better understand a registrant's business, particularly when the profitability of segments varies.

Example SEC staff comment: Results of operations — significant components of expense
In regard to your profit and gross profit margin, you disclose the changes were due to lower revenue and continued growth. Please provide greater details regarding the factors contributing to these changes. Please include separate discussions on a consolidated and segment basis the changes in your cost of revenues. To the extent that materially offsetting amounts do not result in net material period-over-period changes, please separately disclose, quantify and discuss the impacts on a gross basis. Please refer to Item 303(a)(3) of Regulation S-K and Section III.F.1 of SEC Release 33-6835.

Key financial and operating metrics

To help investors view the registrant from management's perspective, the SEC's guidance on MD&A requires that the registrant disclose in MD&A the key performance indicators (KPIs), financial or nonfinancial, that are used to manage its business and that would be material to investors. In addition, registrants can elect to provide additional KPIs. These indicators vary by industry. For example, retail companies may use same-store sales and store openings and closings, while social networking and online gaming companies typically focus on the number of monthly or daily users.

When a registrant uses a key metric to discuss operating results in MD&A, the SEC said that it would generally expect, based on the facts and circumstances, the following additional disclosures to accompany the metric:

- A clear definition of the metric and how it is calculated
- A statement indicating the reasons why the metric provides useful information to investors
- A statement indicating how management uses the metric in managing or monitoring the performance of the business

If there are estimates or assumptions underlying the metric or its calculation, the registrant should evaluate whether disclosure of such items is necessary for the disclosure of the metric not to be misleading. If a registrant changes the method by which it calculates or presents the metric from one period to another or otherwise, the registrant should consider the need to disclose, to the extent material:

- The differences in the way the metric is calculated or presented compared to prior periods
- The reasons for such changes
- The effects of any such change on the amounts or other information being disclosed and on amounts or other information previously reported
- Such other differences in methodology and results that would reasonably be expected to be relevant to an understanding of the registrant's performance or prospects

Depending on the significance of the change(s) in methodology and results, the registrant should consider whether it is necessary to recast prior metrics to conform to the current presentation and place the current disclosure in an appropriate context. The SEC also reminds registrants to consider whether effective controls and procedures are in place related to the disclosure of metrics that are material.

The SEC staff recognizes the value of using operating metrics in MD&A to help explain operating results. However, the staff has asked for clarification when it believes that a registrant's use of such metrics without the appropriate context does not adequately explain changes in income statement line items.

Example SEC staff comment: KPIs without appropriate context
You state that the volume of customers with annual recurring revenue has been increasing by a certain number over the past three fiscal years. Please tell us how this information provides investors with information regarding the growth of your company for each period presented. To add context to this information, please disclose your actual customer count for each period presented as well as the percentage of revenue generated from the customers with annual recurring revenue.

Critical accounting estimates

The SEC staff often asks registrants to focus their MD&A discussion of critical accounting estimates on the quality and variability of management's most significant judgments and assumptions.

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 Reporting Release No. 72, *Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations*, reminds registrants that MD&A rules require disclosure of critical accounting estimates and assumptions when both of the following conditions are met:

- 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.

> "Disclosures about critical accounting estimates should focus on the quality and variability of management's judgments and assumptions.

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 significant accounting policies note to the financial statements. 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.

Registrants can consider including in MD&A a cross-reference to the footnote disclosure about significant accounting policies but should not repeat information that is already included in other sections of the filing. MD&A disclosures should be expanded to address why the accounting estimate or assumption bears the risk of change and 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

The SEC staff believes that registrants should provide quantitative information in addition to qualitative information when it is reasonably available and material and may ask a registrant how its discussion of specific critical accounting estimates aligns with information appearing in the notes to the financial statements, in a press release or elsewhere.

Example SEC staff comment: Enhanced disclosure
We note that a sharp decline in your stock price resulted in a significant decline in your market capitalization; however, you concluded that goodwill was not impaired for any business unit but did not provide a discussion of the methodology used to estimate fair value. Tell us how you reconciled and evaluated your market capitalization to the fair value of your reporting units and describe the reasons for significant differences, if any. Please also provide the method(s) you used to estimate the fair value of your reporting units. If more than one method was used, please indicate how you weighted each method. In this regard, please provide qualitative and quantitative descriptions of the material assumptions and factors (e.g., stock prices) used to support each reporting unit's fair value determination and describe the degree of uncertainty associated with your key assumptions. Please refer to Item 303(a)(3)(ii) of Regulation S-K and SEC Release No. 34-48960.

Liquidity and capital resources

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. Such requests may focus on:

- Sources and uses of cash and the availability of cash to fund liquidity needs
- 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 alternative sources of funding and material debt covenants when there is an elevated risk of default or when management has concluded it is reasonably likely that covenants will be violated in the future.

Under the amended rules, a registrant must also describe its material cash requirements, their general purpose and the anticipated source of the funds needed to satisfy them. While this change goes beyond the legacy requirement for disclosures about capital expenditures, the SEC said it does not expect registrants to substantially change current practice.

General disclosures

Item 303 of Regulation S-K requires 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 often requests that registrants expand MD&A to include a meaningful analysis of any variability in cash flows and discuss the material components of these cash flows. For example, the SEC staff often challenges discussions about cash flows that recite items that are readily apparent from the statement of cash flows (e.g., changes in working capital) but do not analyze the underlying drivers for material changes.

Example SEC staff comment: Changes in operating cash flows
It appears from the statement of cash flows that changes in assets and liabilities, which include working capital items, are the substantial cause of the increase in 2019 operating cash flows compared to 2018. Please revise your disclosure to discuss the material items and the associated underlying factors contributing to the variance. Refer to IV.B.1 of SEC Release No. 33-8350 for guidance. Quantify all factors cited and address the material drivers underlying those factors, pursuant to section 501.04 of the staff's Codification of Financial Reporting. Additionally, define what you consider to be your working capital and please note that merely citing changes in working capital items and other items identified in the statement of cash flows may not provide a sufficient basis to understand how operating cash between comparative periods changed.

The SEC staff also has requested that registrants disclose:

- Whether identified trends will continue, and if so, how long they will continue and steps the registrant is taking to address the trends, including plans to remedy any identified material uncertainties or unfavorable trends in short- or long-term liquidity
- 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 amounts available under existing credit arrangements, the anticipated circumstances requiring their use, any uncertainty about the registrant's ability to access these funds when needed and the implications of not being able to access the arrangements

When there is a heightened risk of debt default (e.g., adverse trends in cash flows or operating results, recent covenant waiver requests, significant amount of debt maturing within 12 months), the SEC staff requests enhanced disclosure about alternative sources of funding, 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:

- Alternative sources of funding to refinance existing debt obligations
- Specific terms of material debt covenants and whether the registrant is in compliance with the covenants
- Quantitative information, such as ratios or amounts compared with minimum/maximum ratios or amounts required by debt covenants, along with explanations of how these 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 covenant
- The likelihood of violating financial covenants in the future

“The SEC staff requests enhanced disclosures about alternative sources of funding when there is a heightened risk of debt default.

Example SEC staff comment: Potential risks of liquidity deficiencies
We note that you recently entered into a series agreement with your lenders to extend a significant portion of your near-term debt maturities and to stabilize collateral requirements for your existing surety bond portfolio. Separately, you recently indicated on the earnings call that you may be at risk of breaching a key financial covenant. Please disclose whether you are in compliance with all financial covenants and address the actual or reasonably likely effects of compliance or noncompliance with the financial covenants on your financial condition and liquidity. Refer to section IV.C. of SEC Interpretive Release No. 33-8350.

Contractual obligations

Legacy Item 303 of Regulation S-K requires most registrants to provide tabular presentations of contractual obligations as of the end of the most recent fiscal year with the goal of presenting a meaningful snapshot of the cash requirements arising from such obligations. Over the last year, the SEC staff has questioned the completeness of items included in registrants' contractual obligations tables and has asked those companies to provide their reasons for excluding certain items from the table.

Under the amended rules, registrants are no longer required to include a contractual obligations table. However, the amendments related to liquidity and capital resources, including the requirement for registrants to discuss known contractual and other obligations (e.g., purchase obligations) on both a short-term and long-term basis, are intended to make sure that eliminating the table does not result in a material loss of information for investors.

Under the amended rules, registrants should still provide disclosure that is clear and understandable and that appropriately reflects the categories of obligations that are meaningful in light of their capital structure and business. Registrants are not precluded from continuing to present required disclosures in a tabular format as long as the information is reflected in a manner that is appropriate for their business. Registrants that choose to present a table should consider providing an accompanying narrative disclosure to promote an understanding of the tabular data.

Segment reporting

The SEC staff continues to focus on segment reporting and how registrants apply the guidance in ASC 280. The areas the SEC staff is focusing on include:

- How registrants identify operating segments
- How registrants aggregate operating segments into reportable segments
- Whether registrants have inappropriately included non-GAAP measures in their segment disclosures
- Whether registrants provide appropriate entity-wide disclosures related to products and services, revenues attributable to individual foreign countries and revenues from major customers

> "The term 'chief operating decision maker' defines a function rather than an individual with a specific title.

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 footnotes. 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.

Questions on segment reporting have often resulted in multiple rounds of comments, particularly when the registrant's initial response was not comprehensive.

Identification of operating segments

The segment reporting guidance is 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. To support the management approach concept, the SEC staff has requested that registrants include a discussion of their internal structure or an organizational chart and the processes used to make operating decisions in their comment letter responses.

Identifying operating segments (ASC 280-10-50-1 through 9) is the first step in preparing segment disclosures. A critical element of this analysis is identifying the chief operating decision maker (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 employees who report directly to the 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 helps the SEC staff understand how the CODM assesses performance and allocates resources and whether that is consistent with the operating segments identified.

To qualify as an operating segment, a component of a registrant must have discrete financial information that the CODM uses to assess performance and make resource-allocation decisions. The SEC staff frequently has requested that registrants describe the financial information provided to the CODM so the SEC staff can understand the information used by the CODM to assess performance and allocate resources.

When a registrant identifies only one operating segment, the SEC staff is more likely to challenge 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.

Example SEC staff comment: Identification of operating segments
Although you disclose you have a single reportable segment, we note that during earnings calls management refers to your product lines as "businesses" and that the management team on your website includes Senior Vice President and General Manager positions for the ABC, XYZ and Products Divisions. Please tell us in sufficient detail how you determined that you have only one reportable segment. In doing so, tell us each operating segment you have identified under ASC 280-10-50-1 and provide the following information: ‣ Tell us the title and describe the role of the CODM and each of the individuals who reports to the CODM ‣ Identify and describe the role of each segment manager ‣ Tell us how often the CODM meets with direct reports, what financial information the CODM reviews to prepare for those meetings, what financial information is discussed in those meetings and which other personnel attend those meetings ‣ Describe the information regularly provided to both the CODM and the Board of Directors and how frequently it is prepared ‣ Explain to us the responsibilities of each Senior Vice President and General Manager identified above, including to whom they report and how they are compensated

Aggregation of operating segments

ASC 280 allows, but does not require, a registrant to aggregate operating segments for reporting purposes. To aggregate operating segments, a registrant must determine that all of the following criteria in ASC 280-10-50-11 are met:

- The aggregation must be consistent with the objective and basic principles of ASC 280.
- The operating segments must be economically similar.
- The following five qualitative characteristics of the operating segments must be similar: (1) the nature of the products and services, (2) the nature of the production processes, (3) the type or class of customer for their products and services, (4) the methods used to distribute their products or provide their services, and (5) the nature of the regulatory environment, if applicable.

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 business lines, if they qualify as operating segments, may not be economically similar.

The SEC staff has requested historical and projected operating margins, gross margins, revenue and other measures of operating performance when challenging a registrant's aggregation of operating segments.

When a registrant has aggregated operating segments into a reportable segment, the SEC staff has frequently asked the registrant to explain why it believes that the five qualitative characteristics of the operating segments are similar, as required by ASC 280.

The SEC staff also has reminded registrants that the guidance on determining whether two operating segments are similar requires a company to consider the range of its business activities and the economic environment in which it operates. For example, while one registrant with a diversified product portfolio may consider certain products similar, another registrant with a narrower range of activities may not consider those products similar.

Example SEC staff comment: Aggregation of operating segments
You disclose that you have three operating segments (North America, Europe and Asia). You further indicate that you have aggregated these operating segments into one reportable segment based upon their shared customer base and similar economic characteristics. Please explain to us in detail how the customer base is shared and how this meets the applicable criteria for aggregation contained in ASC 280-10-50-11. Likewise, demonstrate how the economic characteristics are similar among the three separate geographic operating segments and how you determined that the segments can be expected to essentially have the same future prospects. In your response, tell us the measure(s) you consider to be economically similar and why you selected such measure(s).

Disclosures

Non-GAAP measures

By definition, a segment measure of profit or loss that a company is required to disclose in accordance with ASC 280 (i.e., the measure of segment profit or loss used by the CODM for purposes of making decisions about allocating resources to the segment and assessing its performance) is not a non-GAAP measure and is not subject to the SEC's rules and regulations on the use of non-GAAP financial measures. However, registrants should be aware that a consolidated measure of segment profit may create a non-GAAP financial measure and would require compliance with Item 10(e) if used anywhere outside the required ASC 280 reconciliation.

The SEC staff recently has observed an increase in the number of companies disclosing multiple measures of segment profit or loss in the notes to their financial statements and has said that registrants should not attempt to circumvent the non-GAAP rules by doing this. Companies should consider the appropriate measure of profit or loss that should be disclosed in accordance with ASC 280-10-50-22.

That is, if the CODM uses more than one measure of profit or loss to assess performance and allocate resources, the appropriate measure to report is the one most consistent with the measure used to calculate the corresponding amounts in the entity's consolidated financial statements. For example, if the CODM uses operating income and earnings before interest, taxes, depreciation and amortization (EBITDA) to assess performance and allocate resources, the measure of segment profit would be operating income, since that measure is most consistent with US GAAP.

Example SEC staff comment: Non-GAAP measures in the segment footnote
We note you present three different segment profitability measures in your segment footnote. Please be advised that if your CODM uses more than one measure of a segment's profit or loss to assess performance and allocate resources, the measure you report and disclose should be the one that management believes is determined in accordance with the measurement principles most consistent with those used in measuring the corresponding amounts in your consolidated financial statements. Please revise your segment footnote to report one segment profitability measure and remove the other segment profitability measures currently presented. Refer to ASC 280-10-50-22 and ASC 280-10-55-9. Please note that any additional segment profitability measures, presented outside your financial statements and related footnotes, would be non-GAAP financial measures that could only be presented to the extent that they are appropriate and their presentation fully complies with all of the requirements of Regulation G and Item 10(e) of Regulation S-K, including any disclosures presented in Business, MD&A and earnings releases filed under Form 8-K. Refer to the responses to Questions 104.03 and 104.04 of the Compliance and Disclosure Interpretations on Non-GAAP Financial Measures.

"ASC 280 requires entities to disclose certain entity-wide information if it is material, even if it is not used by the CODM to manage the entity.

For further discussion, including Item 10(e) requirements, please refer to the *Non-GAAP measures* section of this publication.

Entity-wide disclosures

ASC 280 also requires a registrant to disclose the following disaggregated financial information if it is material:

- Disaggregated revenue by product and service — revenues derived from transactions with external customers for each product or service, or each group of similar products or services
- Disaggregated revenue by geography — revenue information attributed to the registrant's country of domicile and all foreign countries and separately for each foreign country that is material
- Revenue contributed by significant customers — total revenue from each major customer (i.e., one that contributes 10% or more of total revenues) and the segment(s) in which the revenues are reported

The SEC staff has challenged the absence of these disclosures when the registrant's publicly disclosed information indicates that its reportable segments contain a range of products or services, that there may be material revenue from foreign locations and/or that there may be a concentration of sales attributable to a specific customer.

The SEC staff also has reminded registrants that the entity-wide revenue disclosures required by ASC 280 must be presented in accordance with US GAAP.

Revenue recognition

Disaggregated revenue disclosures

Under ASC 606-10-50-5, registrants are required to disclose disaggregated revenue information to illustrate how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors. While ASC 606 does not specify how revenue should be disaggregated, the implementation guidance in ASC 606-10-55-89 through 91 suggests categories for entities to consider. Over the past year, the SEC staff continued to seek more details about how registrants have considered the implementation guidance when selecting the appropriate categories for disaggregated revenue.

The SEC staff may review all publicly available information to evaluate whether the objectives of this disclosure requirement have been met, and the SEC staff has requested explanations when registrants have not disaggregated revenue in a manner similar to how they have disclosed information in other communications.

Example SEC staff comment: Disaggregated revenue disclosures
We note your disaggregated revenue disclosure by segment and product type in Note XX. Please explain to us how your presentation provides information about how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors. We also note you do not appear to present disaggregated revenue based on when revenue is recognized, including over time and at a point in time. Please tell us how you considered the guidance in ASC 606-10-50-5 and ASC 606-10-55-89 through 91 when determining the appropriate categories to use to disaggregate revenue.

"An entity is required to explain the relationship between the disclosure of disaggregated revenue and revenue information that is disclosed for each reportable segment.

When determining categories for revenue disaggregation, we believe that registrants should analyze the risk factors for each of their revenue streams to determine the proper level of revenue disaggregation that will be beneficial to financial statement users. If certain risk factors could lead to changes in the timing of revenue recognition, those factors should be evaluated as potential categories for this disclosure.

In addition, ASC 606-10-50-6 requires an entity to explain the relationship between the disclosure of disaggregated revenue and revenue information that is disclosed for each reportable segment. Registrants should review their disclosures to verify that they meet this disclosure requirement.

Identifying performance obligations

To apply ASC 606, an entity must first identify the promised goods and services in a contract with a customer and then determine which of those goods and services are separate performance obligations. Promised goods and services represent separate performance obligations if the goods or services are distinct (by themselves or as part of a bundle of goods and services) or if the goods and services are part of a series of distinct goods and services that are substantially the same and have the same pattern of transfer to the customer.

A promised good or service is distinct if both of the following criteria are met: (1) the customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (i.e., the good or service is capable of being distinct) and (2) the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (i.e., the promise to transfer the good or service is distinct in the context of the contract).

Over the past year, the SEC staff continued to seek more details about how registrants identified performance obligations in contracts with customers, including how registrants support their conclusions on whether certain promised goods and services are separately identifiable.

Example SEC staff comment: Identifying performance obligations
We note your disclosure under "identifying the performance obligations" that service agreements are one performance obligation. Please help us fully understand the nature of the various products and services transferred in these agreements and explain to us how you determined that the products and services in these agreements should be combined. Refer to ASC 606-10-25-19 through 22.

Registrants should carefully identify the promises in a contract and evaluate the criteria for determining whether the promises for those goods and services are separately identifiable from other promises in the contract (i.e., whether the promise to transfer the good or service is distinct in the context of the contract). Registrants also should provide detailed disclosures about their performance obligations in contracts with customers, including a description of the nature of the goods or services that they have promised to transfer.

Satisfaction of performance obligations

ASC 606 states that an entity must determine at contract inception whether it will transfer control of a promised good or service over time. If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time. The guidance requires entities to disclose when they typically satisfy their performance obligations (e.g., upon shipment, as services are delivered). Registrants must also disclose significant judgments made in determining the timing of satisfaction of performance obligations.

Further, when an entity has determined that a performance obligation is satisfied over time, ASC 606 requires the entity to select a single revenue recognition method (i.e., measure of progress) that depicts the entity's performance in transferring control of the goods or services and disclose the method selected, including why the method selected provides a faithful depiction of the transfer of goods or services.

Example SEC staff comment: Satisfaction of performance obligations
Please clarify the extent to which your revenues are recognized at a point in time or over time. Please tell us how you determined the contracts that qualify for point-in-time recognition and those that qualify for over-time recognition. Refer to ASC 606-10-25-23 to 30. In addition, please tell us why the method of your choice provides a faithful depiction of the transfer of your goods or services.

Exhibits, signatures and agreements

Forum selection clauses in bylaws

The SEC staff has questioned registrants' use of forum selection clauses, which refers to provisions in bylaws or certificates of incorporation that require litigation to be brought in a particular jurisdiction, such as Delaware state courts. These forum selection clauses may be found in bylaws or certificates of incorporation included as exhibits to Form 10-K. For example, the staff has requested that registrants include an expanded disclosure regarding how such provisions interact with jurisdictional provisions found in the Exchange Act and Securities Act.

Example SEC staff comment: Exclusive forum selection provision in bylaws included as an exhibit to Form 10-K
We note that your forum selection provision, in section ten of your Certificate of Incorporation filed as Exhibit 3.3, identifies the Court of Chancery of the State of Delaware as the exclusive forum for certain litigation, including any "derivative action." Please disclose whether this provision applies to actions arising under the Securities Act or Exchange Act. In that regard, we note that Section 27 of the Exchange Act creates exclusive federal jurisdiction over all suits brought to enforce any duty or liability created by the Exchange Act or the rules and regulations thereunder, and Section 22 of the Securities Act creates concurrent jurisdiction for federal and state courts over all suits brought to enforce any duty or liability created by the Securities Act or the rules and regulations thereunder. If the provision applies to Securities Act claims, please also state that there is uncertainty as to whether a court would enforce such provision and that investors cannot waive compliance with the federal securities laws and the rules and regulations thereunder.

Section 302 certifications

The management certification required under Section 302 of the Sarbanes-Oxley Act must be filed as Exhibit 31 to Form 10-K. The form of this 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 the principal financial officer.

The SEC staff frequently asks registrants to correct these certifications by refiling them in an abbreviated amendment. Most often, the staff comments on the exclusion of language regarding internal control over financial reporting (ICFR) when this language became effective for the issuer's first annual report required to contain management's report on ICFR (i.e., the second Form 10-K as a public company).

When preparing officer certifications, registrants should follow the precise form specified by Item 601(b)(31) of Regulation S-K and include the required language on ICFR 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 for newly public companies to comply with Item 308(a) of Regulation S-K).

Example SEC staff comment: Section 302 certifications
It appears your officer certifications filed under Exhibits 31.1 and 31.2 do not include the language referring to ICFR that should appear in the introductory sentence of paragraph 4 of the Section 302 certifications. Please note this additional language became effective for your first annual report required to contain management's report on ICFR and in all periodic filings thereafter. Please revise your filings to include the correct certifications. We refer you to the guidance under C&DI for Regulation S-K, Question 246.13.

Goodwill and intangible assets

The SEC staff has requested additional disclosure and information about goodwill and other intangible assets, including:

- Disclosures about reporting units that may be at risk of goodwill impairment
- Details about the timing of impairment charges
- Information about the registrant's impairment testing policies
- Disclosure of the methodologies, estimates and underlying assumptions used in the registrant's impairment analysis

Goodwill impairment analysis and disclosures

Reporting units at risk of impairment

The SEC staff has frequently asked registrants to provide additional disclosure when the future impairment of goodwill represents a known uncertainty required to be disclosed in MD&A. The SEC staff often makes this request when the registrant's operating results (or those of the relevant segment) have declined significantly.

To assist registrants in meeting this disclosure obligation, the SEC staff refers to disclosures in Financial Reporting Manual (FRM) Section 9510.3 that registrants should provide when any reporting unit's estimated fair value does not substantially exceed its carrying value (i.e., the reporting unit is at risk of failing a future impairment test under ASC 350). The SEC staff guidance on COVID-19 disclosures also says registrants should consider whether they anticipate material impairments of goodwill or intangible assets.

Example SEC staff comment: Reporting units at risk of impairment
Considering the significant decline in revenues for the three and six months ended June 30, 2020, please provide information for investors to assess the probability of future goodwill impairment charges. Please note that a reporting unit is at risk of failing step one of the impairment test if it has a fair value that is not substantially in excess of carrying value. If a reporting unit is not at risk based on your most recent impairment test, please disclose this, as we believe it provides valuable information in assessing the sensitivity of your goodwill to future impairment. In addition, for any reporting unit that is at risk of failing step one of the impairment test and a material impairment charge could occur, please disclose the following: ▸ The percentage by which fair value exceeded carrying value as of the date of the most recent impairment test and the amount of goodwill allocated to the reporting unit. ▸ A detailed description of the methods and key assumptions used to determine the estimated fair value and how the key assumptions were determined. ▸ A discussion of the degree of uncertainty associated with each key fair value assumption, including the potential impact of changes in key assumptions. The discussion regarding uncertainty should provide specifics to the extent possible (e.g., the valuation model assumes recovery from a business downturn within a defined period of time). ▸ A description of potential events and/or changes in circumstances that could reasonably be expected to negatively affect the key assumptions.

“The SEC staff has challenged the timing of a goodwill impairment charge when the conditions that resulted in the charge appeared to exist in prior periods.

The SEC staff has stated that it expects a registrant to apply judgment when determining whether the fair value is not substantially more than the carrying amount and, thus, a reporting unit's goodwill is considered to be at risk. The disclosures in FRM Section 9510.3 should be provided if any reporting units are at risk. 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 goodwill impairment test, the SEC staff expects the registrant to disclose that fact in MD&A.

The SEC staff also has challenged the timing of a goodwill impairment charge, particularly when the conditions that resulted in the charge appeared to exist in prior periods. In addition, the SEC staff has questioned whether adequate disclosure was made in previous filings when a goodwill impairment charge was recorded for a reporting unit that was not previously disclosed as being at risk.

Information on impairment analysis

The SEC staff has asked for information about a registrant's impairment analysis, including:

- The 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
- The sensitivity of the 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 test
- A reconciliation of the aggregate fair values of the reporting units to the registrant's market capitalization and support for the implied control premium
- An analysis of events that have occurred since the last goodwill impairment test and whether those events are indicators of impairment that require an interim test

- The reasons for and the result of any goodwill impairment test, even if no impairment was recognized
- The types of events that could lead to a future goodwill impairment

The SEC staff will review publicly available information in addition to periodic reports (e.g., news reports, press releases, investor presentations) to identify potential indicators of impairment. Common reasons the SEC staff has cited for issuing comments on a registrant's impairment analysis include significant declines in results and/or market capitalization, reduced product pricing, changes to the competitive landscape and impairments recorded by a registrant's peers.

The SEC staff may also comment on a registrant's disclosure that it tested goodwill and intangible assets for impairment and concluded that they were not impaired. We have also observed the SEC staff request information about why an impairment review was not triggered for certain assets or reporting units when a registrant has tested other assets or reporting units for impairment, and the conditions that triggered the impairment review appear to apply to the assets not tested.

Example SEC staff comment: Potential indicators of impairment
We note as a result of the uncertainty and challenging operating environment created by the COVID-19 pandemic, you completed an interim impairment review of the goodwill and other long-lived assets of reporting units [A] and [B]. We note the pandemic also adversely impacted your [C], [D] and [E] reporting units, and there has been a substantial decline in your market capitalization. Furthermore, you disclosed you expect the results for most of your divisions will continue to be adversely impacted by the pandemic for the remainder of 2020. Please explain why an interim impairment review was not triggered for your other reporting units. Reference is made to ASC 350-20-35-3, ASC350-20-35-30 and ASC 350-30-35-18.

Disclosure of critical accounting estimates

When the SEC staff obtains more information from a registrant about its impairment analyses, it has often asked the registrant to add disclosure to its critical accounting estimates section in MD&A about assessing goodwill for impairment. These requests often focus on:

- The accounting policies related to the goodwill impairment tests, including when the 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
- How the fair value of each reporting unit was estimated, including the significant assumptions and estimates used

Other intangible asset impairment

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. Long-lived assets to be held and used (including finite-lived intangible assets) are tested for impairment (in accordance with ASC 360) when factors exist that indicate that the carrying amount of a long-lived asset or asset group may not be recoverable.

The SEC staff has requested disclosures similar to those described in FRM Section 9510.3 with respect to other intangible assets when it believes a risk of impairment exists. The SEC staff has also asked registrants to disclose how other intangible assets are tested for impairment, including the valuation methods and significant assumptions used to determine the estimated fair values of the assets. As it has done with goodwill impairment, the SEC staff has challenged whether impairments of other intangible assets should have been recognized when the staff observes potential indicators of impairment.

When goodwill impairment occurs, the SEC staff often requests an explanation of how the registrant considered the factors that led to that impairment in evaluating the need for impairment testing of other intangible assets.

Example SEC staff comment: Other intangible assets
We note you performed an interim goodwill impairment test due to the expected impact of COVID-19 on your financial results. Please tell us whether you also evaluated your intangible assets balance for recoverability due to this significant adverse change in the business climate. Refer to guidance in ASC 350-30-35-14 and ASC 360-10-35-21(c).

Other comment areas

Contingencies

Accounting for and disclosure of loss contingencies

“ The SEC staff expects disclosures about loss contingencies to evolve and include more quantitative information as a matter progresses.

Loss contingencies continue to be an area of focus for the SEC staff. In its comments on registrants' compliance with the disclosure requirements in ASC 450, the SEC staff typically focuses on whether reasonably possible losses have been disclosed and the overall clarity and timeliness of the disclosures.

The SEC staff often questions whether a registrant has failed to make the required disclosure in the notes to the financial statements regarding reasonably possible losses, including reasonably possible losses in excess of the amount accrued. Registrants must disclose an estimate of the amount or range of such losses.

If a registrant cannot estimate the amount or range of reasonably possible loss, it should include a statement that such an estimate cannot be made. However, over the last year, the SEC staff has questioned how a registrant determined that an estimate of a reasonably possible loss or range of loss cannot be made.

While the SEC staff acknowledges that there are many uncertainties and potential outcomes associated with loss contingencies, registrants should undertake sufficient procedures to support their conclusions, including determining which of the potential outcomes are reasonably possible and what the range of losses would be for those outcomes. The SEC staff may also request additional disclosures about the specific barriers to making an estimate and when the registrant expects those factors to be alleviated.

Example SEC staff comment: Disclosure about reasonably possible losses
We note your disclosure that it is reasonably possible that additional exposure to estimated future claims in excess of the amount accrued could have a material, unfavorable impact on the financial statements. If it is at least reasonably possible that a loss exceeding amounts already recognized may have been incurred and the amount of that additional loss would be material, either disclose the estimated additional loss, or range of loss that is reasonably possible, or state that such an estimate cannot be made. Please describe your consideration, analysis and conclusions regarding any amounts of probable or possible losses pursuant to ASC 450.

The SEC staff expects disclosures about loss contingencies to evolve and include more quantitative information as a matter progresses. The SEC staff also sometimes tracks this evolution in periodic filings and may challenge the timing of recorded losses or the adequacy of earlier disclosures when a loss contingency appears to have been resolved unexpectedly. For example, a registrant that has been actively resolving a high volume of legal matters that have arisen in a short period of time could consider providing a rollforward of its litigation reserves similar to the schedule required by Rule 12-09 of Regulation S-X to enhance the clarity of its disclosures and facilitate the reader's understanding of the progression of the contingencies and expected losses.

Inventory and cost of sales

The SEC staff has challenged registrants that have disclosures stating that inventory is carried at the lower of cost or market when the inventory is measured using any method other than last-in, first-out or the retail method. Pursuant to ASC 330-10-35-1B, inventory measured using other methods (e.g., the first-in, first-out method, the average cost method) must be measured at the lower of cost and net realizable value. The staff has frequently requested registrants to update their future filings with the appropriate disclosures.

Example SEC staff comment: Inventory subsequent measurement disclosure
Your disclosure states that inventory is reflected at the lower of cost or market value under the first-in, first-out method. Please revise your future filings to clarify, if true, that your inventory is measured at the lower of cost or net realizable value consistent with ASC 330-10-35-1B.

The SEC staff continues to 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 proper classification of costs and expenses applicable to sales and revenues in accordance with Rule 5-03(b) of Regulation S-X.

Example SEC staff comment: Cost of revenue
Please disclose the nature of expenses included in the cost of revenue line item.

The SEC staff has also focused on the adequacy of disclosures related to certain costs of inventory that were expensed as research and development expense by biotechnology and pharmaceutical companies prior to regulatory approval of products.

Example SEC staff comment: Inventory costs
You disclose that certain manufacturing costs associated with shipments of product X were expensed prior to FDA approval and, therefore, were not included in cost of goods sold as of December 31, 2019, and March 31, 2020. Please tell us and provide proposed disclosure to be included in future periodic reports that addresses the following: ‣ The cost of the inventory buildup prior to your regulatory approval that had been expensed in prior periods as research and development expenses (i.e. zero cost inventories) ‣ The estimated selling value of zero cost inventory on hand at March 31, 2020, and when you expect, based on your current sales trends, the zero cost inventories to be depleted ‣ The shelf life of your inventory and your consideration of whether any additional inventory will be determined to be obsolete in future periods

Income taxes

The SEC staff continues to focus on inadequate or overly general (i.e., boilerplate) disclosures in the financial statements and MD&A that discuss how a registrant evaluated the realizability of deferred tax assets and whether a valuation allowance is required. In particular, the SEC staff frequently asks registrants to provide more information about their assessment of all available positive and negative evidence used to determine the realizability of deferred tax assets, how the evidence was weighted and the extent to which the evidence was objectively verifiable.

Example SEC staff comment: Realizability of deferred tax assets
We note that you reversed your deferred tax valuation allowance in fiscal 2019 after considering the existence of recent cumulative income from continuing operations as a source of positive evidence. We also note that you regularly review deferred tax assets for recoverability based upon an analysis of all positive and negative evidence, including expected future book income based on historical data and the expected timing of the reversals of existing temporary differences. Please provide additional detail that supports your decision to reverse the valuation allowance in fiscal 2019, including the nature of the positive and negative evidence, as well as assumptions used in your analysis. Also, provide similar information that supports your determination of the deferred tax valuation allowance at December 31, 2020.

ASC 740 also requires a registrant to reconcile the effective income tax (i.e., the reported amount of income tax expense attributable to continuing operations for the year) to statutory income tax (i.e., the amount of income tax expense that would result from applying domestic federal statutory tax rates to pretax income from continuing operations). The SEC staff has requested more information about the nature of reconciling items that have significantly affected a registrant's effective tax rates. These comments often relate to operations located in foreign jurisdictions that have low tax rates.

Example SEC staff comment: Nature of reconciling items that affected effective tax rates
We note the line item "Change in U.S. tax status of foreign entities" in your tax rate reconciliation table. Please revise to describe the nature of this significant reconciling item. Refer to ASC 740-10-50-12. Further, to the extent your current effective tax rate is not indicative of future results, please revise to include in MD&A a discussion of the impact such a shift may have on your future results of operations. Refer to Item 303(a)(3) of Regulation S-K and Section III.B. of SEC Release 33-8350.

Internal control over financial reporting and disclosure controls and procedures

While they do not appear on the list of most frequent comment areas by the SEC staff, comments on ICFR and disclosure controls and procedures (DCPs) continue to be challenging for companies to resolve. The SEC staff has questioned the following areas related to ICFR and DCPs:

- The implications for ICFR and DCPs when a registrant discloses an error correction, regardless of whether it is material
- The effectiveness of DCPs when management concludes that ICFR is ineffective
- The nature of material weaknesses and the timeliness of their identification
- The omission of disclosures about changes in ICFR after significant events that make material changes likely, such as a business combination or a significant accounting change

- Disclosure of cybersecurity incidents and their implications on the assessment of DCPs

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, describe 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 also may question whether the correction of immaterial errors affects current and previous conclusions related to the effectiveness of ICFR and DCPs.

If a registrant determines that its ICFR or its DCPs (or both) were effective despite the immaterial error correction, the SEC staff may challenge the basis of these conclusions. In particular, the SEC staff often questions the nature of the deficiency that resulted in the error and the likelihood that the deficiency could result in a material misstatement. The SEC staff has said that registrants sometimes focus their evaluation on the accounting error itself rather than whether a control had an ineffective design or failed to operate effectively.

The SEC staff may also question management's judgment when it attributes a material error to a control deficiency but does not conclude that the deficiency is a material weakness.

Example SEC staff comment: Immaterial error correction and ICFR

We note that you identified an error in the calculation of the loss on disposal of discontinued operations recorded in the year ended December 31, 2020. Please address the following with regard to your internal control over financial reporting (ICFR) and disclosure controls and procedures (DCPs):

- Explain to us how the error was discovered and by whom. Include in your response further details on the nature of the error and the reason(s) for the impact on each financial statement line item affected.
- To the extent that you determined there were control deficiencies that led to the incorrect accounting for the noted transaction, describe in reasonable detail the control(s) that failed and how you evaluated the severity of each identified control failure for each period it existed. Refer to the guidance for evaluation of control deficiencies beginning on page 34 of SEC Release No. 33-8810 "Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934." Include in your analysis a description of the maximum potential amount or total amount of transactions exposed to the deficiency and explain how you made that determination.

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

Example SEC staff comment: Inappropriate management assessments

Revise to disclose whether your evaluations of your Disclosure Controls and Procedures and Internal Controls over Financial Reporting concluded that your controls were effective or ineffective. Similarly, revise your disclosure in your March 31, 2020, Form 10-Q to disclose whether your Disclosure Controls and Procedures were effective or ineffective. Refer to Items 307 and 308 of Regulation S-K.

DCPs include components of ICFR that (1) relate to the maintenance of records that fairly reflect an issuer's transactions, (2) provide reasonable assurance that the transactions are properly recorded to permit the preparation of financial statements in accordance with US GAAP and (3) provide reasonable assurance that unauthorized transactions that could have a material effect on the financial statements have been prevented.

The scope of these procedures would generally include ICFR because they apply to all material information to be included in a report, in and outside the financial statements. The SEC staff has challenged registrants that say they concluded that ICFR was ineffective but DCPs were effective.

Example SEC staff comment: DCPs and ICFR
We note you determined that a material weakness existed in your internal control over financial reporting due to the lack of segregation of duties, and you concluded that your internal controls over financial reporting were ineffective as of December 31, 2020. We also note you concluded that your disclosure controls and procedures were effective as of December 31, 2020. Please more fully explain to us how management was able to conclude that disclosure controls and procedures were effective. Please be reasonably detailed in your response and explain why the material weakness you identified did not impact your disclosure controls and procedures, as defined in Exchange Act Rules 13a-15(e) and 15d-15(e). Your explanation should also be included in your Item 9A disclosures. Alternatively, please revise your Item 9A disclosures to conclude that your disclosure controls and procedures were also ineffective as of December 31, 2020.

"If management concludes that ICFR was ineffective, it should carefully consider the implications for the effectiveness of DCPs.

The SEC staff also has questioned why a registrant's disclosures under Item 308(c) of Regulation S-K did not identify a material change in ICFR during a quarter when a registrant (1) concludes its ICFR and/or DCPs are ineffective due to a new material weakness or (2) reports the remediation of a previously reported material weakness.

Example SEC staff comment: Changes in ICFR
We note that two material weaknesses were remediated as of March 31, 2020, and your internal controls over financial reporting were effective. On page 18, you disclose that recent system improvements have not been fully effective in preventing attacks on your data and breaches to your security. Considering that you expect to transition more of your processes throughout the remainder of calendar year 2020, and that you require most team members to work from home to the extent possible, please consider the need to disclose any changes in internal controls over financial reporting in future periodic reports. Please refer to Corporation Finance Disclosure Topics 9 and 9A.

In addition, with the increase in the frequency and severity of cyber attacks and data breaches, cybersecurity disclosures continue to be an area of focus. The SEC staff has encouraged companies to adopt comprehensive policies and procedures related to cybersecurity and to assess their compliance regularly, including the sufficiency of their DCPs as they relate to disclosure of cyber attacks and data breaches.

In light of cybersecurity incidents that pose a risk to a company's ability to record, process, summarize and report information that is required to be disclosed, the SEC staff has asked registrants, as part of broader questions about incidents, how management considered whether there are deficiencies in DCPs that would render them ineffective.

Example SEC staff comment: Cybersecurity incident's effect on DCPs
We note your reference within the Form 10-K and in a Form 8-K that the Company had a data breach that affected XX million users. You indicated, to date, unauthorized users have not had a material effect on your Company. Please tell us how you reached such a conclusion. Additionally, tell us how you considered disclosure of the following, hereunder, elsewhere in this filing and in your Form 10-Q: ‣ The details of such an incident, including your assessment of its magnitude and financial, legal or reputational consequences ‣ Why there was a delay between the date of the incident and the date it was reported ‣ How you considered the cybersecurity incident in your assessment of DCPs ‣ Any action you have taken to remediate the incident and mitigate the harm

Looking ahead

This year, we expect the SEC staff to continue to monitor how registrants address the accounting and reporting implications of the COVID-19 pandemic, including their accounting for past and future government relief.

The SEC staff may comment on how companies apply the amendments to Regulation S-K pertaining to MD&A. The staff may also comment on priority topics reflected in the SEC's regulatory agenda, such as disclosure relating to climate risk; human capital, including workforce diversity and corporate board diversity; and cybersecurity risk.

We understand the SEC staff recently has started issuing comments to companies relating to the Commission's 2010 guidance on climate-related disclosures as part of its increased focus on disclosures related to environmental, social and governance (ESG) matters. The SEC's Division of Corporation Finance posted a **sample comment letter** on the SEC website to illustrate the types of comments it may issue to companies regarding their compliance with the 2010 guidance. For more information on how to apply the Commission's guidance in this area, refer to our Technical Line, ***Revisiting the SEC's guidance on climate change disclosures in today's environment***.

In addition, the staff may ask how registrants have considered whether to disclose the material effects of risks related to changes to their business that may be necessary to respond to climate risk. These risks could affect registrants' disclosures about their business, financial condition and results of operations (e.g., new policy and regulatory changes). The SEC staff may also ask registrants whether the information included in their sustainability reports should also be included in their annual reports.

How we see it

We expect to see the Division of Corporation Finance continue to address issuers' climate-related disclosures through the comment process, even while rulemaking on this topic is underway. We urge registrants to consider the applicability of the 2010 guidance in their disclosures and to continue to reevaluate those disclosures as their businesses evolve.

The SEC staff has also highlighted reference rate reform as a future focus area and emphasized that companies should provide disclosures in MD&A about their plans for the transition away from the London Interbank Offered Rate if the effects are expected to be material.

Endnotes:

1 SEC Chairman Jay Clayton and Division of Corporation Finance Director William Hinman issued a **statement** urging companies to provide as much information as practicable about their current operating and financial status and future plans in earnings releases and calls with analysts and investors. The SEC staff issued **Disclosure Guidance: Topic No. 9**, which provided its views on disclosure and other securities law obligations that companies should consider with respect to COVID-19. The guidance provided questions on a wide range of topics that registrants can use to help develop disclosures about the effects of COVID-19. The division supplemented this guidance with **Disclosure Guidance: Topic No. 9A,** which focused on the effects of COVID-19 on companies' operations, liquidity and capital resources, and provided another round of questions on these matters that registrants can consider. The SEC's Chief Accountant Sagar Teotia issued statements in **April** 2020 and **June** 2020 emphasizing the importance of high-quality financial reporting related to the COVID-19 pandemic.

2 See Public Statement by John Coates **"SPACs, IPOs and Liability Risk under the Securities Laws,"** 8 April 2021.

3 **Release 33-10890**, *Management's Discussion and Analysis, Selected Financial Data, and Supplementary Financial Information* (Final rule).

Appendix

This appendix lists other EY resources on the topics addressed in this publication.

COVID-19 observations

- Technical Line, ***Accounting and reporting considerations for the effects of the coronavirus outbreak (revised 4 June 2020)***
- To the Point, ***Relief provided by the CARES Act will affect accounting and financial reporting***
- Technical Line, ***How to appropriately use non-GAAP measures to discuss the effects of COVID-19***
- Technical Line, ***Accounting for impairment of goodwill and indefinite-lived intangible assets due to the coronavirus***
- To the Point, ***SEC extends relief and issues staff guidance on COVID-19 disclosures***

IPOs and SPAC mergers

- Technical Line, ***Navigating the requirements for merging with a special purpose acquisition company***
- To the Point, ***Pro forma financial information: a guide for applying amended Article 11 of Regulation S-X***

Non-GAAP measures

- Technical Line, ***A closer look at the SEC staff's scrutiny of non-GAAP financial measures***
- ***2020 SEC annual reports — Form 10-K***

MD&A

- *To the Point*, ***SEC issues guidance on disclosures about key performance indicators and other metrics in MD&A***
- ***2020 SEC annual reports — Form 10-K***
- ***2020 AICPA Conference on Current SEC and PCAOB Developments***

Segment reporting

- Financial reporting developments, ***Segment reporting***

Revenue recognition

- Financial reporting developments, ***Revenue from contracts with customers (ASC 606)***

Goodwill and intangible assets

- Financial reporting developments, ***Intangibles — goodwill and other***
- Financial reporting developments, ***Fair value measurement***

Income taxes

- Technical Line, ***Accounting for the income tax effects of the CARES Act and the COVID-19 pandemic***
- Financial reporting developments, ***Income taxes***

ICFR

- *2020 SEC annual reports — Form 10-K*
- *2020 AICPA Conference on Current SEC and PCAOB Developments*
- Financial reporting developments, ***Accounting changes and error corrections***
- SEC Reporting Update, ***SEC issues guidance on cybersecurity***

Looking ahead

- To the Point, ***SEC streamlines some Regulation S-K disclosures and requires human capital disclosures***
- Technical Line, ***Revisiting the SEC's guidance on climate change disclosures in today's environment***
- To the Point, ***SEC eliminates certain MD&A requirements and revises others to make disclosures more useful***