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SEC Reporting Update

Highlights of trends in 2022 SEC comment letters

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What you need to know

- Non-GAAP financial measures remained in the top spot on our list of the most frequent topics in SEC staff comment letters for the year ended 30 June 2022. Also consistent with the previous year, management's discussion and analysis and segment reporting were second and third, respectively.
- Climate-related disclosures moved into the top 10 topics for the first time, and we expect the SEC staff to continue to focus on these disclosures in its reviews of year-end reporting, even as the SEC works to finalize the proposed rules.
- The volume of SEC staff comment letters on periodic reports increased 10% from the previous year, reversing the downward trend of recent years.
- The SEC staff has also been asking registrants about the effects of macroeconomic factors such as inflation, the economic fallout of the war in Ukraine and COVID-19. We expect this trend to accelerate.
- The SEC staff has started to issue comment letters relating to the amended management's discussion and analysis requirements in Regulation S-K.

Overview

Non-GAAP financial measures, management's discussion and analysis (MD&A), and segment reporting once again took the top three spots on our list of topics the Securities and Exchange Commission (SEC or Commission) staff addressed most frequently in comment letters for the year ended 30 June 2022.

Building a better working world

Climate-related disclosures moved into the top 10 for the first time, and we expect the SEC staff to continue to scrutinize these disclosures, even as the Commission works to finalize new rules[1] to require more extensive disclosures in the future. On average, the comments on climate-related disclosures also required more rounds of comments to resolve than comments on other topics on our top 10 list.

The climate-related comments focused on compliance with the **Commission's 2010 climate change guidance** and whether disclosures a registrant made voluntarily in a separate corporate social responsibility (CSR) or sustainability report should appear in the annual report filed with the SEC. The SEC staff had indicated that it would ask those types of questions in the **sample letter on climate change disclosures** it posted on the SEC website last year.

In our review of SEC staff comment letters on periodic reports, we also found that the volume of letters increased 10% from the previous year, reversing the downward trend of the past 11 years. However, the SEC staff still issued fewer comment letters than it did in 2020, and therefore, we have not seen a return to prior levels.

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.

> "The SEC staff focused on registrants' compliance with existing guidance on climate-related matters.

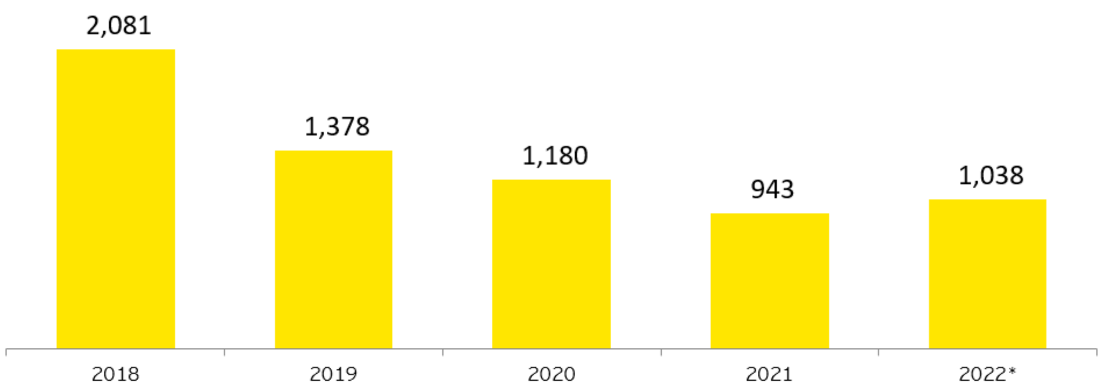
Registrants receiving comment letters from the SEC staff should view the process as an opportunity to educate the staff about their facts and how they arrived at the conclusions leading to their disclosure, rather than an indication that revisions are necessary. This should also include the registrant's consideration of materiality. Appendix A provides considerations and tips for navigating the comment letter process. For example, registrants should avoid over reliance on precedent responses from other companies and be aware that a lack of comment doesn't necessarily mean the matter has concurrence from the SEC staff.

Trends in 2022 SEC staff comment letters

Number of SEC staff comment letters trends upward

The SEC staff's recent focus on climate-related disclosure matters was a key contributor to the 10% increase in SEC staff comment letters in the year ended 30 June 2022.

Number of SEC comment letters by year

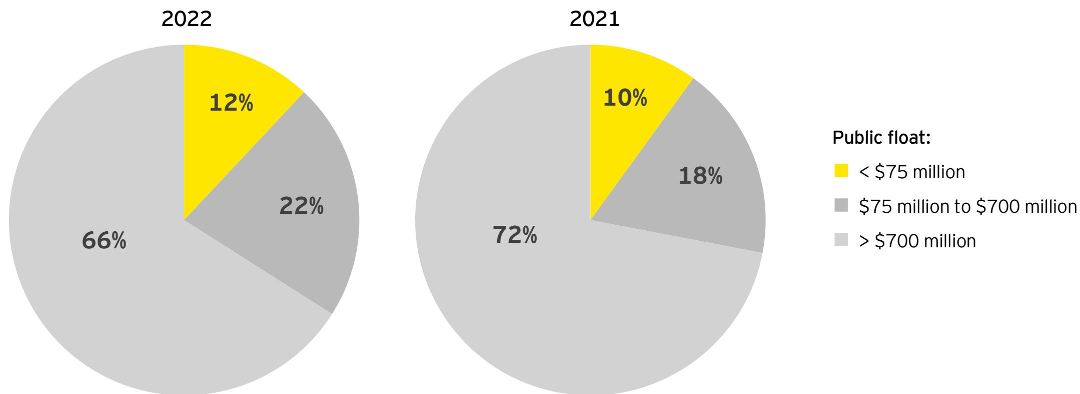


Source: Audit Analytics – SEC UPLOAD of comment letters related to Forms 10-K and 10-Q that were publicly available during the 12-month periods ended on 30 June each year.

* 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 and, therefore, are not included herein.

The SEC staff continued to use its risk-based approach, which involves concentrating on larger issuers and reviewing their filings more frequently. We believe this approach has led to an overall improvement in disclosure, which had contributed to the downward trend in prior years.

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 2022 and 30 June 2021.

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 generally has 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 continued to focus on many of the same topics we highlighted last year. Non-GAAP measures and MD&A continued to draw the most scrutiny from the SEC staff, followed by segment reporting. Revenue recognition also remains a focus of SEC staff comments.

But as discussed above, climate-related disclosures moved into the top 10 comment areas, and the SEC staff generally requested that companies provide additional information on this topic in a second (or third) round of comments. The comments were consistent with the sample letter the SEC staff issued on this topic.

Comments on acquisitions and business combinations also made it into the top 10 this year, mainly driven by an increase in deal activity. Comments on contingencies (ranked eighth last year) and income taxes (ranked tenth last year) dropped out of the top 10 this year.

The following chart lists the top 10 most frequent comment areas in the current and previous years along with the average number of letters per registrant on the respective topic (i.e., number of comment letter "rounds" it took to resolve the staff's concerns).

Comment area	Ranking 12 months ended 30 June[1] 2022	2021	Comment area received as a % of registrants receiving comment letters 2022	Average letters per registrant[3] 2022
Non-GAAP financial measures	1	1	44%	1.4
Management's discussion and analysis (MD&A)[2]	2	2	36%	1.1
Segment reporting	3	3	15%	1.2
Revenue recognition	4	4	11%	1.2
Fair value measurements	5	5	9%	1.1
Climate-related disclosures	6	N/A[4]	8%	2.2
Inventory and cost of sales	7	9	7%	1.3
Signatures/exhibits/agreements	8	6	7%	1.0
Goodwill and intangible assets	9	7	6%	1.1
Acquisitions and business combinations	10	N/A[4]	6%	1.2

1 These rankings are based on topics assigned by research firm Audit Analytics for SEC comment letters issued to registrants with a market capitalization of $75 million or more on Forms 10-K and 10-Q from 1 July 2021 through 30 June 2022 and the comparable period, respectively. In some cases, individual SEC staff comments are assigned to multiple topics if the same comment covers multiple accounting or disclosure areas.

2 For the year ended 30 June 2022, this category includes comments on MD&A topics, excluding climate-related disclosure matters, in order of frequency: (1) results of operations (67%), (2) liquidity matters (13%), (3) critical accounting policies and estimates (11%) and (4) business overview (9%). Many companies received MD&A comments on more than one MD&A topic.

3 This represents the number of comment letters (or rounds of comments) that were issued by the SEC staff for the given comment area during the 12 months ended 30 June 2022.

4 This topic was not among the top 10 in 2021.

Climate-related disclosures

The SEC staff's comments on climate-related disclosures are aligned with the **sample comment letter** that the SEC's Division of Corporation Finance posted on the SEC website in September 2021 to illustrate the types of comments it had begun issuing to companies about their compliance with the **Commission's 2010 guidance regarding disclosure related to climate change**. That guidance in Regulation S-K says companies may need to make disclosures about climate-related matters in the description of the business (Item 101), discussion of legal proceedings (Item 103), risk factor disclosures (Item 105) and/or MD&A (Item 303). Securities Act Rule 408 and Exchange Act Rule 12b-20 also require a company to disclose any other material information necessary to make the required disclosures not misleading.

The staff's comments focus on registrants' climate-related disclosures of:

- The impact of climate legislation, regulation and international accords
- Indirect consequences of climate-related regulation or business trends
- The physical effects of climate change
- Material expenditures for climate-related projects and increases in compliance costs

The SEC staff has also asked registrants why climate-related information they provide voluntarily in CSR reports was not also provided in annual reports. The staff had indicated in the sample letter that it also would ask these types of questions.

Impact of legislation, regulation, and international accords

The SEC staff has asked registrants to disclose the risks they face as a result of climate change legislation, regulation, treaties and international accords if the risks are reasonably likely to have a material effect on the registrant's business, financial condition and results of operations. Disclosure is required, unless management determines that a material effect is not reasonably likely. The SEC staff has issued these comments when disclosure about climate change is lacking or the disclosure in the annual report appears generic or boilerplate in nature.

Registrants also have to consider disclosure, if material, of the difficulties they face in assessing the timing and effect of proposed legislation, regulation or international accords.

Example SEC staff comment: Climate-related legislation, regulation and international accords
Please tell us whether you have identified any pending climate change-related legislation, regulations, and international accords that could have a material effect on your business, financial condition, and results of operations. Please also tell us your process for identifying such developments and how you assessed potential materiality. In addition, explain how you considered providing disclosure addressing the difficulties involved in assessing the timing and effect of pending climate-related laws, regulations, or guidance.

Indirect consequences of regulation or business trends

The 2010 guidance notes that regulatory developments and business trends regarding climate change may result in indirect consequences or opportunities for registrants, including:

- Decreased demand for goods that produce significant greenhouse gas emissions
- Increased demand for goods that result in lower emissions than competing products
- Increased competition to develop innovative new products
- Increased demand for generation and transmission of energy from alternative energy sources
- Decreased demand for services related to carbon-based energy sources, such as drilling services or equipment maintenance services
- Reputational damage

The SEC staff has continued to request more robust disclosures to address the indirect consequences of climate change.

Example SEC staff comment: Indirect consequences of regulation or business trends
If material, please discuss with greater specificity the indirect consequences of climate-related regulation or business trends, such as the increased demand for goods that result in lower emissions or are related to alternative energy sources and strategic opportunities that may arise for your company as a result of climate change.

Physical effects of climate change

The 2010 guidance says registrants should also consider disclosure of the significant physical effects of climate change, such as weather events (e.g., floods, hurricanes), rising sea levels, a decrease in arable farmland, and water availability and quality, that have the potential to materially affect or that have materially affected a registrant's operations and results. The SEC staff has asked registrants to disclose these effects, including quantifying material weather-related damage to property or operations, the potential for indirect weather-related impacts on the registrant's major customers or suppliers, and weather-related impacts on the cost or availability of insurance.

Example SEC staff comment: Physical effects of climate change
Please tell us in more detail how you considered providing a discussion of the significant physical effects of climate change on your operations and results. As part of your response, address the potential indirect weather-related impacts that have affected or may affect performance by third parties of their responsibilities under various contractual or service arrangements and government programs. In addition, tell us whether you considered catastrophe losses resulting from events such as hurricanes, hailstorms, tornadoes, and wind activity as being a physical effect of climate change and your basis for concluding that such losses have not or will not have a material impact on your business, financial condition, results of operations, or cash flows.

Expenditures for climate-related projects and increases in compliance costs

The SEC staff has asked registrants to describe the nature of their climate-related projects and quantify material past expenditures and planned future expenditures for such projects. The staff has asked about projects or planned projects that registrants discuss in CSR reports, on their websites and in other public forums. The staff has also referred to the environmental goals and commitments a registrant has communicated publicly as an indication that the registrant may be incurring or will incur climate-related project expenditures.

Example SEC staff comment: Expenditures for climate-related projects
Your proxy statement and the environmental stewardship portion of your website describe several climate-related projects you have or plan to undertake. If material, please quantify any past or planned future capital expenditures for climate-related projects.

The staff has also asked registrants to quantify any material increase in compliance costs related to climate change.

Example SEC staff comment: Increases in compliance costs
We note your environmental regulations disclosure, including your disclosure that compliance with each enumerated environmental regulation did not materially impact your operations, costs, and/or results. Please revise your disclosure to quantify any material increased compliance costs related to climate change, including compliance costs associated with these regulations in the aggregate.

Information provided in registrants' CSR reports

The SEC staff has also challenged registrants when certain climate-related disclosures appear in CSR reports but not in annual reports.

Example SEC staff comment: Information provided in registrants' CSR reports
We note that you provided more expansive disclosure in your CSR report than you provided in your SEC filings. Please advise us what consideration you gave to providing the same type of climate-related disclosure in your SEC filings as you provided in your CSR report.

Multiple rounds of letters

The SEC staff has often issued multiple rounds of letters on climate-related disclosures or reissued the same comments, particularly when the registrant's initial response does not address each of the items in the initial comment letter. Additionally, when registrants assert that the effects or costs of climate-related matters are not material, the SEC staff has asked them to quantify the effects or costs and explain their analysis of materiality. As a result, the average number of rounds of climate-related comments was higher than the average number of rounds of comments on any other topic in our top 10 list. The example below illustrates the staff's issuance of additional letters after a registrant has responded to an initial comment letter.

Example SEC staff comment: Multiple rounds of comment letters regarding climate-related disclosures

Round 1 comment:

If material, discuss the significant physical effects of climate change on your operations and results. This disclosure may include quantification of material weather-related damages to your property or operations and any weather-related impacts on the cost or availability of insurance.

Round 2 comment:

Your response to our previous comment states that you did not incur material weather-related damage to your properties or other disruptions of your operations during the time periods covered by your 10-K. Please provide us with quantitative information to support this statement.

Round 3 comment:

In response to our previous comment, you state that you did not experience a material limitation on the availability of weather-related insurance or a material increase in the cost of insurance. Please provide us with additional information quantifying the weather-related impacts on the cost of insurance and explain your materiality assessment. In addition, tell us how your disclosure specifically addresses the effects of climate change on the availability of insurance.

Macroeconomic observations

The SEC staff has been issuing comments on periodic reports and registration statements on the effects of macroeconomic factors, including the economic fallout of the war in Ukraine and related sanctions, supply chain issues, and the impact of inflation and rising interest rates.

Since we expect the SEC to continue issuing these types of comments, we encourage registrants to consider the questions the SEC staff raised in a sample **comment letter** on the direct and indirect effects of the war in Ukraine, since many of them could apply to the accounting and disclosure considerations relating to various macroeconomic factors.

War in Ukraine and related sanctions

After publishing a sample comment letter regarding disclosures of the direct and indirect effects of the war in Ukraine and related supply chain issues in May, the SEC staff has issued comments that track the same themes. The SEC staff has reminded registrants that they have obligations to provide detailed disclosures, to the extent material or otherwise required, about matters such as:

- Impacts on a registrant's business (e.g., reliance on goods or services sourced in Russia or Ukraine and business relationships in, connections to or assets in Russia, Belarus or Ukraine) or, if the impacts are not material, an explanation of why they are not material

- Any known trends or uncertainties that would have a material impact on a registrant's cash flow, liquidity, capital resources, cash requirements, financial position or results of operations
- New or heightened risk of cyber attacks

The SEC staff has also asked registrants whether they need to evaluate their long-lived and other assets for impairment or make disclosures about their critical accounting estimates related to the impairment of assets.

Example SEC staff comment: Impairment considerations in relation to the war in Ukraine
We note your disclosure regarding Russia's invasion of the Ukraine and that such events may negatively impact your results of operations, cash flows and financial condition. Please describe in greater detail the impact of the war on your business, including the impact to your supply chain, specific impacts from sanctions and export controls, and whether you will need to evaluate any aspects of your business for impairment. If the impact is not material, please explain why.

The SEC staff asked some registrants to provide more information about specific risk factors when the disclosures have been limited to general statements about uncertainties created by the war in Ukraine and related sanctions (e.g., risk related to the registrant's reputation in connection with operations or halted operations in affected regions).

Example SEC staff comment: Risk factor disclosure
To the extent material, please disclose the risk that you may suffer reputational damage arising from your ongoing operations in Russia given Russia's invasion of the Ukraine and the current conflict. Disclose that this could negatively impact the overall demand for your products or services and your results of operations. Additionally, disclose any known trends or uncertainties that have had or are reasonably likely to have a material impact on your liquidity, financial position, or results of operations as a result of the conflict.

COVID-19

While the SEC staff issued fewer comments on disclosures related to COVID-19 in the year ended 30 June 2022, it continued to ask some registrants to discuss the impacts of the COVID-19 pandemic on their results of operations in greater detail, including how they expect COVID-19 to impact their future operating results.

Example SEC staff comment: MD&A disclosure — COVID-19 historical results
We note that the COVID-19 pandemic has had an impact on billings and revenue, and you have taken actions intended to mitigate the effects of the COVID-19 pandemic on your business, such as the reduction of expenses. Please quantify how these items contributed to your historical performance and are expected to impact future results, to the extent reasonably available. Refer to Item 303(b)(2)(ii) of Regulation S-K.

The SEC staff also continued to issue comments on non-GAAP measures adjusted for the effects of the COVID-19 pandemic. These comments mainly requested more information about the nature of the non-GAAP adjustments, whether the adjustments were appropriate under Item 10(e) of Regulation S-K and the method used to calculate them.

Example SEC staff comment: COVID-19 non-GAAP adjustments

We note your non-GAAP measure Adjusted EBITDA includes an adjustment for "other," under note (f), and your measure Management EBITDA includes an adjustment (g), which includes a number of items. Please address the following:

- Provide us with further description and quantification for the adjustments underlying these amounts;
- Revise your disclosure to break out individually significant adjustments; and
- Clearly tell us how you determined that your adjustments for the impact of adoption of accounting standards and costs in connection with COVID-19 are appropriate under Item 10(e) of Regulation S-K.

Other macroeconomics factors

The SEC staff has asked registrants to disclose more information about how supply chain disruptions impact their business. The requests generally ask a registrant to quantify and explain its analysis of the impact on its liquidity and capital resources. The SEC staff has also asked about known and anticipated events and trends that may impact the registrant's future liquidity and capital resources as a result of the supply chain issues.

The SEC staff has also requested that registrants discuss whether recent inflationary pressures have materially impacted their operations and identify the types of inflationary pressure they are facing and how their business has been affected. Further, the staff has asked registrants to identify actions planned or taken, if any, to mitigate inflationary pressure. The SEC staff has also asked registrants to discuss in detail whether inflation (or supply chain disruptions) have materially affected their outlook or business goals.

Example SEC staff comment: Supply chain issues and inflation

We note your statement that global supply chain disruptions and shortages continue to pressure your margins and that you made progress in recovering some of these additional costs from your customers through increased pricing. Please discuss in future filings in detail whether supply chain disruptions or inflation have materially affected your outlook or business goals. Specify whether these challenges have materially impacted your results of operations or capital resources and quantify, to the extent possible, how your sales, profits, and/or liquidity have been impacted. Revise also to discuss in future filings any known trends or uncertainties resulting from mitigation efforts undertaken, if any. Explain whether any mitigation efforts introduce new material risks, including those related to product quality, reliability or regulatory approval of products.

How we see it

Given the persistence of inflation and the expectation that interest rates will continue to rise, we expect to see more SEC staff comments on macroeconomic factors. Registrants should carefully evaluate how economic conditions may affect their business and provide disclosures related to these matters in sufficient detail.

Non-GAAP measures

The SEC staff continues to focus on whether non-GAAP financial measures reported by registrants comply with Item 10(e) of Regulation S-K and the SEC staff's compliance and disclosure interpretations (C&DIs) on this topic, including whether certain performance measures 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 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 other communications (e.g., websites, investor presentations) that may contain non-GAAP measures.

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 does either of the following:

- 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). The staff also often asks registrants to clearly label and describe non-GAAP measures and related adjustments in sufficient detail so investors can understand all material components and distinguish them from GAAP measures.

The staff has also issued comments when a registrant's calculation of a non-GAAP measure appears different from the typical calculation of the measure. For example, the staff has asked registrants to revise the title of their "free cash flow" non-GAAP measures (e.g., to "adjusted free cash flow") when the measures are calculated as something other than cash flows from operating activities, less capital expenditures.

Example SEC staff comment: Definition of a non-GAAP measure
We note you present "operating net working capital" in discussing your cash flows from operating activities. Please identify operating net working capital as a non-GAAP financial measure and provide the required disclosures pursuant to Item 10(e) of Regulation S-K. To the extent you do not believe this is a non-GAAP measure, please explain.

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 in these locations 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 believes that, to comply with the requirement to present the comparable GAAP measure with equal or greater prominence, a registrant needs to present and provide any discussion and analysis of 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 gives the non-GAAP information undue prominence.

Example SEC staff comment: Prominence of non-GAAP measures
Please expand your disclosure to include discussion and analysis, with equal or greater prominence, of the most directly comparable GAAP financial measure to underlying measures. We note that your results of operations discussions primarily focus on the year-over-year changes in the underlying measures as opposed to movements in the GAAP measures. Refer to Item 10(e)(1)(i)(A) of Regulation S-K and Question 102.10 of the Compliance and Disclosure Interpretations on Non-GAAP Financial Measures.

The SEC staff has also 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 adequately explain why a measure is useful, the SEC staff may consider that as an indication that the measure may be misleading.

Example SEC staff comment: Usefulness of a non-GAAP measure
Please tell us and revise future disclosures related to your Contribution Margin non-GAAP financial measure to address the following: ‣ Explain how management uses the measure. ‣ Explain the purpose of the measure. ‣ Explain the specific nature of each adjustment to the measure, including the reasons for each adjustment. For example, explain how you determined what selling and distribution expenses and other operating expenses to not reflect in the measure, and explain why you believe that is meaningful and appropriate.

Registrants must also reconcile a forward-looking non-GAAP measure to the comparable GAAP measure if the latter is available without unreasonable efforts. If a forward-looking non-GAAP measure cannot be reconciled to a comparable GAAP measure without unreasonable effort, registrants must disclose that fact, along with the specific information that is not available and its significance. This disclosure should be made with the same or greater prominence as that of the forward-looking non-GAAP measure.

Example SEC staff comment: Reconciliation of forward-looking non-GAAP measures
Please provide quantitative reconciliations for your forward-looking non-GAAP financial measures to the comparable GAAP measures. If the GAAP measure is not accessible on a forward-looking basis, disclose that fact and provide reconciling information that is available without an unreasonable effort. Furthermore, identify the specific information that is unavailable and disclose its probable significance. Refer to Item 10(e)(1)(i)(B) of Regulation S-K and Section II.B.2 of SEC Release No. 33-8176.

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.

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

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. The SEC staff in the past generally focused on adjustments to revenue, but it has broadened its approach in recent years to challenge 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 generally not appropriate for companies that adopt Accounting Standards Codification (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. The SEC staff has only accepted adjustments for credit losses in limited situations (e.g., excluding credit losses from distributable income reported by companies in the mortgage real estate investment trust industry).

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
- Combine consolidated and unconsolidated results or balance sheet amounts

Example SEC staff comment: Individually tailored accounting principle
You state that the tax adjustments, net includes an adjustment to normalize the impact of the valuation allowance that affects your annual effective tax rate. Your valuation allowance adjustment appears to result in an individually tailored income tax recognition method. Please revise your presentation to omit this adjustment or tell us why you believe it is appropriate. Refer to Question 100.04 of the staff's Compliance and Disclosure Interpretations on Non-GAAP Financial Measures.

How we see it

There are no established criteria for identifying an individually tailored accounting principle. Registrants should consider objections made by SEC staff in the comment letter process to non-GAAP measures to determine whether they should make any adjustments to their own measures. When considering adjustments to non-GAAP financial measures, registrants should consider the implications on their corporate investor reporting if the staff were to object and not permit use of the measure or adjustment.

The SEC staff has continued to emphasize 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 (KPI).

The staff also said some companies have presented as "net revenue" a measure calculated by adding back a portion of the cost of revenue. A registrant that presents such a measure should make it clear that it is a margin calculation, and it should not use the term "revenue" in the title. The registrant should also reconcile the measure to gross margin as defined in the Financial Accounting Standards Board (FASB) Master Glossary. 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 exclusions of charges that appear to be prohibited by the C&DIs, such as:

- Costs to be a public company (e.g., liability insurance for public company directors and officers, investor relation costs, listing fees)
- Certain legal and regulatory expenses

Further, while we have not seen the staff ultimately object to certain frequent restructuring costs, we have recently seen an increase in staff comments on this topic.

Example SEC staff comment: Exclusion of normal, recurring cash operating expenses
We note the adjustment for restructuring costs in your calculation of adjusted earnings. We also note that the recurring expenses were incurred to reduce cost structure and enhance operating effectiveness, improve profitability and eliminate certain redundancies, all ordinary activities necessary to operate your business. Please explain why you do not view these expenses to be normal and recurring expenses of your business. Refer to Question 100.01 of the Non-GAAP Financial Measures Compliance & Disclosure Interpretations.

Over the last year, the SEC staff has also challenged whether expense exclusions common in the pharmaceutical industry were appropriate. The SEC staff issued comment letters to several pharmaceutical companies challenging the following expenses commonly excluded by members of that industry:

- Upfront and contingent milestone payments in connection with collaborative and licensing arrangements (or research and development (R&D) arrangements)
- Acquired in-process research and development (IPR&D) assets charged to R&D costs in an asset acquisition

"The SEC staff remains focused on a detailed level of discussion when explaining the results of operations.

The SEC staff concluded that it is not appropriate for registrants to present a non-GAAP financial measure that excludes these items because such expenses are normal, recurring operating expenses for that industry. In addition, the SEC staff required the affected registrants to modify their non-GAAP presentations immediately, which is a departure from the historical practice of allowing companies more time to implement such changes.

Management's discussion and analysis

The SEC amended Regulation S-K in November 2020 to eliminate certain disclosure requirements and revise several others to make the disclosures provided in MD&A more useful to investors. These amendments were required to be applied for a registrant's first fiscal year ending on or after 9 August 2021. Therefore, the discussion below includes the SEC staff comments with respect to registrants' application of the amended MD&A requirements. Specifically, we have seen the SEC staff comment on the application of a number of amendments to Item 303 of Regulation S-K to modernize and simplify the MD&A requirements.

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 (e.g., R&D expenses, selling, general and administrative 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. In addition, the SEC staff has requested registrants to explain and/or disclose how key metrics are calculated, how management uses the metric in managing or monitoring the performance of the business, and why the metric is useful to investors.

The SEC staff continues to ask registrants to provide a more detailed discussion about their results of operations, including requesting that they:

- Discuss the effects of factors that contributed to material period-to-period changes in quantitative and qualitative terms, 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 (e.g., revenues attributable to significant new customers, the change is related to acquisitions versus organic growth, components of cost of sales, R&D costs)
- 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 (e.g., the impact of COVID-19)
- Discuss reportable segment information needed to understand their results of operations

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 reminds the registrant that it is required to comply with amended Item 303 of Regulation S-K, including providing the reasons for material changes, in quantitative and qualitative terms, for each factor.

The SEC staff has also requested that companies provide certain 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 (e.g., the effects of economic situations). 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 the determination on whether the trend or uncertainty is "reasonably likely," it must assume that the trend or uncertainty will occur and provide disclosure in MD&A, unless it is not reasonably likely to have a material effect.

Example SEC staff comment: Results of operations — quantitative and qualitative factors and known trends and uncertainties

In light of the material fluctuations in your income statement line items and the significant impact of the acquisition, please revise to provide more informative disclosures pursuant to SEC Release No. 33-10890 and Item 303(b)(2) of Regulation S-K.

More specifically, and in order for an investor to better understand the reasons for the fluctuations and to see the analysis through the eyes of management, please revise future filings to discuss the underlying reasons for material changes in quantitative and qualitative terms in all situations in which one or more line items in the financial statements reflect material changes from period to period, including those in which material changes within a line item offset one another.

For example, given this and the significance of cost of sales, please revise future filings to separately quantify and discuss factors responsible for changes in the levels of cost of sales.

In this regard, also disclose any known events that are reasonably likely to cause a material change in the relationship between costs and revenues. Also refer to the aforementioned Release for guidance on establishing the "reasonably likely" threshold.

Significant components of financial condition and results of operations

The SEC staff has asked registrants to expand their discussions about significant components of financial condition and results of operations (e.g., costs of sales, service revenue). 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 financial condition and results of operations 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
Item 303(c) of Regulation S-K requires the inclusion of a discussion of the material changes in the items specifically in paragraph (b) of Item 303 to enable readers to assess material changes in your financial condition and results of operations. Given that you have three reportable segments, please add a discussion of the relevant reportable segment information necessary to understand changes in the significant components of your revenues and expenses.

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 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, which 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 staff expects it to appropriately classify the information disclosed (i.e., as a non-GAAP measure or a metric) and follow the appropriate guidance on presentation and disclosures (e.g., **the Commission's guidance** for KPIs and Item 10(e) of Regulation S-K for non-GAAP measures). The SEC staff also 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 staff 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
In order to give investors more insight into why revenue increased, please disclose the underlying reasons for the increase in monthly active customers. For example, what portion of the growth is related to acquisitions versus organic growth. Discuss the reason for any organic growth if applicable. Also, since you discuss contribution per customer in your results of operations, please disclose this metric and how it is calculated in your Key Financial and Operating Metrics. We refer to guidance in Item 303 of Regulation S-K.

> "Disclosures about critical accounting estimates should include the sensitivity of reported amounts to the method and assumptions underlying the estimate.

Critical accounting estimates

The SEC staff continues to ask registrants to focus their MD&A discussion of critical accounting estimates on the quality and variability of management's most significant judgments and assumptions under the amended Regulation S-K rules.

Critical accounting estimates, as defined by Item 303(b)(3), are those that involve a significant level of estimation uncertainty and have had, or are reasonably likely to have, a material impact on the registrant's financial condition or results of operations.

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.

The amended rules clarify that the critical accounting estimates disclosure must supplement, but not duplicate, the disclosures in financial statements. Therefore, 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 as necessary to address why the accounting estimate or assumption bears the risk of change and provide the following, if material:

- Quantitative and qualitative information to help investors understand the impact of estimation uncertainty on a registrant's financial condition or operating results
- Why the estimate is subject to uncertainty
- How much the estimate and/or assumption has changed over a relevant period
- The sensitivity of the reported amounts to the methods, assumptions and estimates underlying the estimate's calculation

Therefore, the SEC staff may ask registrants to provide both quantitative and qualitative information when it is reasonably available and material to investors and also may ask how their discussion of specific critical accounting estimates aligns with information appearing in the notes to the financial statements, in a press release or elsewhere.

Since critical accounting estimates and assumptions are based on matters that are highly uncertain, the SEC staff believes that companies should also analyze their specific sensitivity to change based on other outcomes that are reasonably likely to occur and would have a material effect.

Example SEC staff comment: Enhanced disclosure

We note that the allowance for credit losses is estimated based on management's assessment of several factors, including: reviews and evaluations of specific loans, changes in the nature and volume of the loan portfolio, current economic conditions, nonperforming loans, determination of acquired loans as purchase credit deteriorated, and reasonable and supportable forecasts. Please provide us proposed revised disclosure to be included within future filings that address the following items:

- Identifies key quantitative inputs in your estimate of the allowance for credit losses
- Explains and quantifies how these key quantitative inputs have changed from period to period
- Quantifies the qualitative component(s) of your estimate and explains or shows how it interacts with the quantitative component during the period presented
- Details the length of time in your reasonable and supportable forecasts and the reversion method you applied after the reasonable and supportable forecast period, if applicable

Refer to Item 303(b)(3) of Regulation S-K and ASC 326-20-50-11.

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 the sources and uses of cash, including:

- The availability of cash to fund liquidity needs
- Underlying drivers of changes in operating, investing and financing activity cash flows
- Known trends and uncertainties reasonably expected to have material effects on the future sources and uses of cash

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.

Registrants must also describe their material cash requirements, their general purpose and the anticipated source of the funds needed to satisfy them. Further, although registrants are no longer required to include a contractual obligations table, they are required to discuss known contractual (e.g., lease obligations) and other obligations (e.g., purchase obligations) on both a short-term and long-term basis. This requirement is intended to make sure that the elimination of the contractual obligations table does not result in a material loss of information for investors.

Registrants' disclosures should clearly reflect 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.

Item 303 of Regulation S-K also 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
Please provide a more fulsome comparative analysis of the $XX million and $XX million decrease in cash provided by operating activities so that investors may fully understand the reason for the decreases between periods. For example, explain the underlying reasons for the working capital items cited. Refer to Item 303 of Regulation S-K, Release No. 33-10890 that emphasizes the need for analysis and the introductory paragraph of section IV.B and paragraph B.1 of Release No. 33-8350 for more specific guidance regarding the analysis of operating cash flows. Also refer to section 501.04 of the staff's Codification of Financial Reporting Releases regarding quantification of variance factors cited.

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
The disclosure indicates that your term loan has no financial maintenance covenants. Given the materiality of this item to your liquidity, please disclose whether the loan includes any subjective acceleration clauses or cross-default provisions.

“The term ‘chief operating decision-maker’ defines a function rather than an individual with a specific title.

Segment reporting

The SEC staff continues to focus on segment reporting and how registrants apply the guidance in ASC 280, *Segment Reporting*. The areas of SEC staff focus for this topic 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

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 may result 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 it 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
You state that your operations constitute one operating and reportable segment. However, we note that you discuss revenue, costs and measures by region and product in the Form 10-K and Forms 10-Q. We further note that you present a managing director for each region on your website. As such, please address the following: ‣ Provide us with details about your management structure and how your company is organized ‣ Describe the role of your CODM and each of the individuals reporting to the CODM ‣ Describe the role of each of your regional managing directors ‣ Describe the key operating decisions, who makes these decisions, how performance is assessed, and how resources are allocated within your business ‣ Tell us how often the CODM meets with her direct reports, the financial information the CODM reviews in conjunction with those meetings, and the other participants at those meetings ‣ Explain how budgets are prepared, who approves the budget at each step of the process, the level of detail discussed at each step, and the level at which the CODM makes changes to the budget ‣ Describe the basis for determining the compensation for each individual that reports to the CODM

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 has also 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.

The SEC staff has also asked registrants to disclose the factors used to identify their reportable segments, including the basis of organization, in accordance with ASC 280-10-50-21, and whether the operating segments have been aggregated into reportable segments in accordance with ASC 280-10-50-11.

Example SEC staff comment: Aggregation of operating segments
Please tell us and disclose the factors used in determining your reportable segments, including whether operating segments have been aggregated. Refer to ASC 280-10-50-21. If you are aggregating operating segments, please also tell us in detail the analysis you performed in determining the criteria in ASC 280-10-50-11 were met. If you are not aggregating operating segments, please explain in detail how the lower-level operating results discussed on your earnings calls and in your Item 2.02 Forms 8-K are not indicative of your operating segments being at a lower level than your reportable segments.

Disclosures

ASC 280 requires certain "first-level" disclosures (e.g., revenue by segment, a measure of profit or loss and assets by segment) for reportable segments, and additional "entity-wide" disclosures (e.g., revenues for the entire entity, organized by products and services and by geographic area).

Measure of profit or loss for reportable segments

By definition, a segment measure of profit or loss for reportable segments 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 or loss 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 has continued to observe a 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 your presentation of more than one profit measure for each of your reportable segments: gross profit and segment operating income. We further note that you consider segment operating income to be the more important metric. ASC 280-10-50-22 requires disclosure of a single measure of segment profit, and ASC 280-10-50-28 indicates that, when more than one segment profit measure is utilized, the one with the measurement principles most consistent with GAAP becomes the segment measure of profit or loss. Please revise all applicable disclosures within your filing to present only that single measure of segment profit or loss for each segment and reconcile to your consolidated income measure as required by ASC 280-10-50-30(b). In addition, please note that additional segment profit or loss measures may be presented outside of your financial statements and footnotes as non-GAAP measures.

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

“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.

Entity-wide revenue disclosures

The following entity-wide disclosures, if material, are required under ASC 280 regardless of whether that information is provided to or used by the CODM:

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

Reconciliations

The SEC staff has commented on registrants' omission of one or more of the reconciliations required by ASC 280-10-50-30 or when the reconciliation provided does not reconcile to the appropriate measure(s) required by ASC 280 (e.g., the reconciliation reconciles the profit or loss measurement to consolidated gross profit rather than to consolidated income before income taxes).

Example SEC staff comment: Segment disclosures on reconciliations
Revise in future filings to reconcile total segment gross profit to consolidated income before income taxes rather than consolidated gross profit. See ASC 280-10-50-30.

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 55-91 suggests categories for entities to consider.

This guidance states that when an entity selects the categories, it should consider how the information about its revenue has been presented for other purposes, including outside the financial statements and in information regularly reviewed by the CODM.

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 continues to review all publicly available information, including MD&A and earnings calls, to evaluate whether the objectives of this disclosure requirement have been met. 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 that the chart on page XX of MD&A, which discloses revenue by market type, is more detailed than the disaggregated revenue disclosure in Note X to the financial statements. Please revise your disclosure in Note X to include a similar detailed level of revenue by market or explain to us why you do not believe that information is required. See guidance in ASC 606-10-55-90.

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 users of financial statements. 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 25-22.

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 it 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 25-30. Please provide revised disclosures in future filings of the method(s) used to recognize revenue for those contracts that qualify for over-time recognition. In addition, please tell us why the method provides a faithful depiction of the transfer of your goods or services.

Business combinations

Application of ASC 805, *Business Combinations*

Definition of a business

Companies that engage in business combination transactions must determine whether a transaction represents a business combination (i.e., the acquired activities and assets constitute a business) or an asset acquisition in accordance with ASC 805. This determination, which may require significant judgment, is critical because the accounting for a business combination differs significantly from that of an asset acquisition. Please refer to our Financial reporting developments publication, ***Business combinations***, for more information on the application of the guidance in ASC 805.

The SEC staff has asked registrants to support their conclusions that their acquisitions meet the definition of a business under ASC 805. The staff has also asked registrants to expand their disclosure to provide further insight on how the conclusion was made.

Example SEC staff comment: Application of ASC 805
We note you completed the acquisitions of Company A and Company B. Please more fully explain how you determined each acquisition is the acquisition of a business. Provide your analyses based on the criteria in ASC 805-10-55-3A through 55-6 and 805-10-55-8 through 55-9. Please expand your disclosures to provide additional insight as to how you determined that it should be accounted for as a business combination under ASC 805.

Additional disclosures

ASC 805 requires registrants to provide various disclosures associated with business combinations, subject to materiality. These disclosures help users of financial statements evaluate the nature and financial effect of business combinations. The SEC staff has requested that registrants expand their disclosures about business combinations to provide the information required by ASC 805. For example, the staff has asked registrants to include the pro forma information required by ASC 805-10-50-2(h), information about the identification and determination of the fair value of acquired intangible assets, and a qualitative description of the factors that make up goodwill.

ASC 805-10-50-2(h) requires pro forma disclosures assuming the acquisition occurred as of the beginning of the comparable prior annual reporting period. When pro forma disclosures are not provided, the SEC staff has asked the registrant to explain why it is impracticable for the registrant to prepare the disclosures or why the disclosure is not material. It is important to note that the evaluation of materiality for this purpose is separate and distinct from the significance test performed for the purposes of presenting pro forma financial information in accordance with Article 11 of Regulation S-X.

SEC staff comments related to business combinations also include inquiries focused on the values assigned to specific identifiable intangible assets, including the significant estimates and assumptions used in calculating fair value measurements. When goodwill resulting from a business combination represents a significant portion of the consideration transferred, the SEC staff has asked registrants to revise their disclosures to provide more detailed qualitative descriptions of the factors that make up the amount of goodwill recognized (e.g., the specific synergies expected from the business combination) as required by ASC 805-30-50-1.

Application of Rule 3-05 and Article 11 of Regulation S-X

A registrant that determines it has acquired a business (based on the SEC's definition in Rule 11-01(d)) is required to provide financial statements in accordance with Rule 3-05 and pro forma financial information in accordance with Article 11 if the business is significant to the registrant. Significance is measured using the asset test, the investment test and the income test described in Rule 1-02(w). For more information on how to apply the SEC rules in this area, including the significance tests, see our Technical Line, ***Applying the SEC's new requirements for significant acquired businesses***.

Over the past year, the SEC staff has sought more details about how registrants concluded that separate financial statements and pro forma financial information were not required under Rule 3-05 and Article 11, respectively. The SEC staff may also review publicly available information, other than SEC filings, to identify any acquisitions completed by the registrant.

When the SEC staff has identified an acquisition that the registrant completed, and the registrant did not file separate financial statements or pro forma information for that business, it has often requested that the registrant provide the relevant significance test calculations and an explanation of its analysis of the requirements of Rule 3-05 and Article 11.

Example SEC staff comment: Application of Rule 3-05 and Article 11 of Regulation S-X
We note you completed the acquisition of all the outstanding stock of Company A for consideration of approximately $XX million. Please explain to us your consideration of the requirements of Rule 3-05 and Article 11 of Regulation S-X related to financial statements and pro forma financial information for the acquisition and provide us with your analysis if you determined these were not required.

Registrants should consider maintaining contemporaneous documentation of significance tests performed and their analysis of Rule 3-05 and Article 11 requirements, particularly when they conclude that an acquisition is not significant.

Exhibits — 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 identifies issues with 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
We note you conducted an evaluation of your internal control over financial reporting, as required by Exchange Act Rules, and provided an assessment and conclusion as to the effectiveness of your internal control over financial reporting, as required by Item 308 of Regulation S-K, in your Form 10-K for the year ended December 31, 20X1. We also note your certifications provided in Exhibits 31.1 and 31.2 do not include paragraph 4(b) and the introductory language in paragraph 4, referring to internal control over financial reporting, that are now required based on the end of the transition period that previously allowed these omissions. Please amend your Form 10-K to provide revised certifications. You may file an abbreviated amendment that is limited to the cover page, explanatory note, signature page and paragraphs 1, 2, 4 and 5 of the certifications. Refer to Exchange Act Rule 13a-14(a) and Item 601(b)(31) of Regulation S-K. Please ensure the revised certifications refer to the Form 10-K/A and are currently dated. This comment is also applicable to your Form 10-Qs for the quarters ended March 31, 20X2 and June 30, 20X2.

Goodwill and intangible assets

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

- Information about the registrant's goodwill and intangible assets impairment testing, including:
  - Disclosure of the methodologies, estimates and underlying assumptions used in the registrant's impairment analyses for both goodwill and intangible assets
  - Disclosures about reporting units that may be at risk of goodwill impairment
- Details about the timing of impairment charges
- Information about assessing goodwill and other intangible assets for impairment that should be included in the critical accounting estimates section of MD&A
- An explanation of how the intangible assets' useful lives and amortization methods were determined

Goodwill 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 them
- The sensitivity of the material assumptions used in testing goodwill for impairment, including quantitative and qualitative 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 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.

> “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.

When the SEC staff obtains more information from a registrant about its impairment analyses, it has often also asked the registrant to add disclosures about assessing goodwill and other intangible assets for impairment to its critical accounting estimates section in MD&A (e.g., how the fair value of each reporting unit was estimated, including the significant assumptions and estimates used). For further discussion, including disclosures about critical accounting estimates, please refer to the MD&A section of this publication.

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 potential indicators of impairment are observed.

To assist registrants in meeting this disclosure obligation, the SEC staff refers to the 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).

Example SEC staff comment: Goodwill impairment analysis

You state that you changed the structure of your internal management reporting in the fourth quarter of fiscal 2021 and identified three operating and reportable segments. You disclose that no indication of impairment was noted for any of your reporting units, as the estimated fair value of each of your reporting units with goodwill exceeded their carrying value. Please clarify for us if any of the reporting units is at risk of failing the impairment test, and if so, please provide the following disclosures for the at-risk reporting units in future filings:

- The percentage by which the fair value exceeded the carrying value as of the date of the most recent test
- The amount of goodwill allocated to the reporting unit
- A description of the methods and key assumptions used, and how the key assumptions were determined
- A discussion of the degree of uncertainty associated with the 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 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 has also challenged the timing of a goodwill impairment charge, particularly when the conditions that resulted in the charge appeared to have existed 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.

Other intangible asset impairment analysis

Under ASC 350, an indefinite-lived intangible asset should be tested for impairment annually or more frequently if events or changes in circumstances indicate that it is more likely than not that the asset is impaired. Under ASC 360, long-lived assets to be held and used (including finite-lived intangible assets) are tested for impairment 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: Goodwill and other intangible asset impairment analysis
We note you have incurred significant losses since inception and expect continued future operating losses. In light of your history of losses and negative cash flows from operating activities for the years ended December 31, 20X1 and December 31, 20X0, please tell us and disclose the results of your annual impairment tests of goodwill, including the significant factors and assumptions used in your analysis. Refer to ASC 350- 20. Additionally, tell us how you determined that the value of intangibles and other assets is recoverable in light of the above factors. Refer to ASC 360-10-35.

Useful life and amortization method determination

The SEC staff focuses on the useful life and amortization method of acquired finite-lived intangible assets (e.g., trade names, customer lists, customer relationships). The SEC staff has asked registrants to disclose how they determined the useful life of these assets and challenged such useful lives when the underlying assumptions do not appear consistent with information disclosed in other areas of the filing.

The SEC staff has also inquired about the amortization method chosen for these assets (e.g., straight-line vs. accelerated) and requested that registrants explain their key assumptions about the expected future cash flows from an acquired intangible asset to support their chosen amortization method.

Example SEC staff comment: Useful life determination — finite-lived intangible assets
We note you recorded $XX billion as the fair value of customer relationships with a weighted average useful life of 15 years. Please tell us how you evaluated the guidance in ASC 350-30-35-3 in determining the useful life, including the characteristics of the customer list that support this assigned life, and all other pertinent factors considered in your analysis.

Historically, the SEC staff has also challenged a registrant's assertions that intangible assets have an indefinite life and has asked them to explain the factors they considered when making this determination.

Other comment areas

Fair value measurements

ASC 820 requires disclosures designed to provide users of financial statements with additional transparency on the valuation techniques and inputs that an entity uses to arrive at its measures of fair value, including judgments and assumptions that it makes, the uncertainty in fair value measurements as of the reporting date, and how changes in fair value measurements affect an entity's performance and cash flows.

The SEC staff questions registrants about their compliance with the disclosure requirements under ASC 820-10-50 when these disclosures are missing, vague or incomplete. The required disclosures include those related to quantitative information about the significant unobservable inputs used in Level 3 measurements.

Example SEC staff comment: Disclosure about fair value measurements
We see that you used Level 3 inputs to determine the fair value of the royalty financing obligation. Please tell us where you provided all of the relevant disclosures required by ASC 820-10-50, including quantitative information about the significant unobservable inputs used in the fair value measurement.

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 classification of costs within 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 may challenge registrants that have excluded depreciation and amortization from their cost of sales to make sure they comply with SEC Staff Accounting Bulletin (SAB) Topic 11.B. The SAB states that to avoid placing undue emphasis on "cash flow," a registrant should not position depreciation, depletion and amortization in the income statement in a manner that results in reporting a figure for income (e.g., gross profit) before depreciation. The SAB also states that if cost of sales excludes charges for depreciation and amortization, the description of the line item should reflect that.

Example SEC staff comment: SAB Topic 11.B
It appears that your gross profit line item does not reflect all the costs of revenue in that, and it excludes the amortization of intangible assets. Please tell us how you determined that your presentation is appropriate and complies with Staff Accounting Bulletin Topic 11.B. Otherwise, revise your presentation to remove the gross profit line item or to present gross profit that reflects all costs of revenue.

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, 20X1, and March 31, 20X2. 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, 20X2, 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
- The estimate of what the gross margin percentage will be after the zero cost inventories are sold.

Internal control over financial reporting and disclosure controls and procedures

While these topics do not appear on our list of most frequent comment areas, the SEC staff continues to issue comments on ICFR and disclosure controls and procedures (DCPs). These comments primarily focus on management's conclusion about the effectiveness of ICFR and DCPs when the registrant has identified accounting errors (regardless of materiality) and compliance with Items 307 and 308 of Regulation S-K.

Accounting errors and ICFR and DCPs assessments

The SEC staff has said that while the existence of a material accounting error is an indicator that a material weakness exists, a material weakness may also exist when there isn't a material error.[2] For example, the SEC staff has challenged the effectiveness of ICFR and DCPs when a registrant corrects an immaterial out-of-period error during the current period without revising prior-period amounts. The SEC reminds registrants that management's assessment must consider the magnitude of the potential misstatement that could result from a control deficiency, and the actual error is only the starting point for determining the potential impact and severity of a deficiency.

In some cases, the SEC staff also challenges management's conclusion about the materiality of an underlying accounting error and requests that registrants provide their analysis supporting the materiality conclusion. The SEC staff has said such an evaluation should objectively consider all relevant facts and circumstances, including both quantitative and qualitative factors.

The SEC staff has also questioned 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: Accounting errors and ICFR and DCPs assessments
We have noted that you identified an error in your net cash provided by operating activities, as presented in your consolidated statement of cash flows for the year ended on December 31, 20X1. Please revise your statements of cash flows for this period to correct this error and consider the need to file an Item 4.02 Form 8-K for non-reliance on previously issued financial statements. Alternatively, provide us with a detailed SAB 99 analysis supporting your conclusion that this error in your statements of cash flows is not material in the period. Also, explain, if true, how you concluded there was not a material weakness in your internal control over financial reporting and how you have concluded that your internal control over financial reporting and disclosure controls and procedures were effective as of December 31, 20X1.

Additionally, when there are indicators of control deficiencies in filings that don't relate to accounting errors, the SEC staff has asked registrants to explain whether those deficiencies were identified by management and, if so, describe their severity, including whether the deficiencies are material weaknesses.

How we see it

We expect the SEC staff to continue asking questions about management's materiality assessment of accounting errors and challenging management's conclusions about the effectiveness of ICFR and DCPs. Resolving these inquiries can often be challenging for registrants, given the judgment involved, and the SEC staff may issue multiple rounds of comments.

Compliance with Regulation S-K

Items 307 and 308 of Regulation S-K require that management's conclusions about the effectiveness of DCPs and ICFR explicitly state whether the DCPs and ICFR are "effective" or "ineffective." Registrants are also required to disclose the framework management used to evaluate the effectiveness of ICFR (e.g., Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission).

Generally, the SEC staff challenges registrants that inappropriately express management's conclusions about DCPs or ICFR (or both) by using language such as "adequate," "effective, except for" or "effective, except as disclosed below." The SEC has also asked registrants to revise management's report on ICFR to specify the framework used.

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, 20X1, Form 10-Q to disclose whether your Disclosure Controls and Procedures were effective or ineffective. Also, please amend the filing to provide a revised management's report on internal control over financial reporting to properly include a statement identifying the framework used by management in such evaluation. Refer to Items 307 and 308 of Regulation S-K.

The SEC staff has also 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 the 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. Additionally, the SEC staff has challenged registrants that say they concluded that ICFR was ineffective but DCPs were effective.

Looking ahead

We expect that the SEC staff will continue to focus on the topics discussed above this year and may expand its comments related to:

- Climate-related disclosures based on the Commission's 2010 guidance in advance of any finalized rule
- The effects of macroeconomic factors, including the impact of inflation, rising interest rates and supply chain issues
- Application of the amended guidance in Regulation S-K related to MD&A
- The materiality evaluation of an error in previously issued financial statements, and how the error was corrected, such as challenging registrants on the overreliance on qualitative factors when concluding that a quantitatively significant error is immaterial

We also expect the following new areas to receive attention from the SEC staff in the coming year:

- Cybersecurity-related disclosures (e.g., risk factors) based on the **Commission's 2018 guidance** on public company cybersecurity disclosures in advance of any finalized rule
- The new pay versus performance rules that will be effective for the proxy and information statements filed in early 2023

Endnotes:

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[1] In March 2022, the SEC proposed new rules to enhance and standardize disclosures that registrants make about climate-related risks, their climate-related targets and goals, their greenhouse gas (GHG) emissions, and how the board of directors and management oversee climate-related risks.

[2] Refer to the **statement** by Paul Munter, Acting Chief Accountant, on 9 March 2022.

Appendix A: 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 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 typically do not extend beyond two letters.

A registrant may commit to modifying its disclosure in the future to resolve certain comments. The SEC staff generally does not require a registrant to amend a filing unless the staff's comment relates to a transaction filing (e.g., an IPO Form S-1 filing) or involves a material omission of a required disclosure or a material restatement of the financial statements.

In addition, registrants should be aware that a lack of comment on a particular matter does not imply the SEC staff has provided concurrence on the matter.

Key considerations and leading practices when drafting the response letter

A registrant generally responds to an SEC comment letter by sending a letter back to the SEC staff. In its response, a registrant should:

- Focus on the question(s) asked by the SEC staff and cite authoritative literature and related guidance wherever possible
- Address its unique facts and circumstances and provide insight into any judgments it made in applying the relevant guidance
  - While it may be helpful for the registrant to consider responses on similar topics by other registrants, the registrant should be cautious when leveraging those responses and avoid overly relying on them because there may be differences in facts that are not readily apparent.
- 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
- Indicate where in the filing it plans to make the revisions to disclosures as a result of the SEC staff comment
  - It can also be helpful for the registrant to provide proposed language in its response letter, but the registrant should make it clear that facts and circumstances may change in a way that could require different disclosure.
- 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 its response is complete and accurate
  - Waiting for another round of comments before involving the necessary resources may delay or hinder a successful resolution.

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

Documentation

Providing a thorough explanation or analysis of an issue to the SEC staff may help it better understand the registrant's accounting and disclosure and often will resolve the comment. To facilitate responses to 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 address materiality when asked why a particular disclosure did not appear in a filing or 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 quantitative and qualitative factors they considered as part of its materiality analysis.

Timing

The SEC staff often requests a written response to its comment letters 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.

Reconsideration

The SEC staff and the registrant may ultimately disagree about an accounting or disclosure matter. The registrant may seek reconsideration of a comment by other SEC staff, such as 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 a staff member's view of its response at any point in the filing review process. There is no formal protocol for registrants to follow when seeking reconsideration, and the 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 SEC staff's accounting conclusion at any stage in the process.

Generally, OCA addresses questions about the application of accounting principles, while the CF-OCA addresses matters related to 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 do so. If all of the relevant information is contained in a registrant's comment letter responses, the registrant does not need to make a separate submission directly to OCA, although it may expedite the process.

Disclosure requirements

The SEC requires that a registrant defined as an accelerated filer, a large accelerated filer or a well-known seasoned issuer disclose, in its annual reports on Form 10-K or Form 20-F, written comments the SEC staff has made in connection with a review of its Exchange Act reports (i.e., Form 10-K) that:

- Are believed to be material by the registrant
- Were issued more than 180 days before the end of the fiscal year covered by the annual report
- Remain unresolved as of the date of the filing of the Form 10-K or Form 20-F

The disclosure must identify the substance of the unresolved comments. SEC staff comments that have been resolved, including those that the SEC staff and the registrant have agreed will be addressed in future Exchange Act reports, do not need to be disclosed. Registrants can provide other information, including their positions regarding any unresolved comments. This information is not required in the registrant's quarterly reports on Form 10-Q.

Appendix B: Resources

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

Climate-related disclosures

- Technical Line, ***Revisiting the SEC's guidance on climate change disclosures in today's environment***

Macroeconomic observations

- Technical Line, ***Accounting and reporting considerations for the war in Ukraine***
- Technical Line, ***Accounting and reporting considerations for the effects of the coronavirus outbreak (revised 4 June 2020)***
- Technical Line, ***How to appropriately use non-GAAP measures to discuss the effects of COVID-19***

Non-GAAP measures

- Technical Line, ***A closer look at the SEC staff's scrutiny of non-GAAP financial measures***
- ***2021 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***
- To the Point, ***SEC eliminates certain MD&A requirements and revises others to make disclosures more useful***
- ***2021 SEC annual reports — Form 10-K***
- ***2021 AICPA & CIMA 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)***

Business combinations

- Technical Line, ***Applying the SEC's new requirements for significant acquired businesses***
- Financial reporting developments, ***Business combinations***

Goodwill and intangible assets

- Financial reporting developments, ***Intangibles — goodwill and other***

Fair value measurements

- Financial reporting developments, ***Fair value measurement***

ICFR

- *2021 SEC annual reports — Form 10-K*
- *2021 AICPA & CIMA Conference on Current SEC and PCAOB Developments*
- Financial reporting developments, ***Accounting changes and error corrections***

Looking ahead

- Technical Line, ***Revisiting the SEC's guidance on climate change disclosures in today's environment***
- Technical Line, ***Accounting and reporting considerations for the war in Ukraine***
- To the Point, ***SEC proposes requiring more cybersecurity disclosures***
- To the Point, ***SEC streamlines some Regulation S-K disclosures and requires human capital disclosures***
- To the Point, ***SEC requires disclosures about the relationship between executive pay and financial performance***