

SEC Comments and Trends

An analysis of current reporting issues
September 2019

The EY logo consists of the letters 'EY' in a bold, white, sans-serif font. A yellow chevron shape is positioned to the right of the letters, pointing towards the top right.

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To our clients and other friends

Every year, we closely monitor the Securities and Exchange Commission (SEC) staff's comments on public company filings to provide you with insights on its areas of focus. Understanding the current financial reporting landscape and the types of issues that the SEC staff is focusing on in its comments will help you as you head into the year-end reporting season.

While this publication highlights areas where the SEC staff has commented in the past, it is not intended to drive changes to your accounting or disclosure unless you determine that changes are necessary to comply with the accounting or disclosure requirements. However, the comments and trends may help you identify disclosure improvements or enhance your documentation of your accounting conclusions.

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

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

Comment area	Ranking 12 months ended 30 June		Comments as % of total registrants that received comment letters*
	2019	2018	2018 and 2019
Revenue recognition	1	5	23%
Non-GAAP financial measures	2	2	35%
Management's discussion and analysis (MD&A)**	3	1	33%
Fair value measurements***	4	3	14%
Intangible assets and goodwill	5	6	10%
Income taxes	6	8	10%
State sponsors of terrorism	7	7	11%
Segment reporting	8	4	11%
Acquisitions and business combinations	9	9	7%
Signatures/exhibits/agreements	10	****	5%

* These rankings are based on topics assigned by research firm Audit Analytics for SEC comment letters issued to registrants about Forms 10-K from 1 July 2017 through 30 June 2019. In some cases, individual SEC staff comments are assigned to multiple topics, if the same comment covers multiple accounting or disclosure areas.

** This category includes comments on MD&A topics, in order of frequency: (1) results of operations (20%), (2) critical accounting policies and estimates (10%), (3) liquidity matters (8%), (4) business overview (6%) and (5) contractual obligations (2%). Many companies received MD&A comments in more than one category.

*** This category includes SEC staff comments on fair value measurements under Accounting Standards Codification (ASC) 820, *Fair Value Measurement*, as well as fair value estimates, such as those related to revenue recognition, stock compensation and goodwill impairment analyses.

**** This topic was not among the top 10 in 2018.

Revenue recognition rose to the top spot as the most frequent area of comment, as most companies adopted the new standard for the first time in their annual reports. Non-GAAP measures also continued to draw significant attention from the SEC staff, along with MD&A and other areas requiring significant judgment, such as fair value measurements, goodwill impairment and income taxes.

Comments issued on revenue recognition have focused on the following areas of judgment:

- ▶ Identifying performance obligations
- ▶ Determining whether a registrant is the principal or an agent in a revenue transaction
- ▶ Estimating variable consideration
- ▶ Meeting the criteria for using the residual approach for estimating selling prices
- ▶ Proper disaggregation of revenue in the notes to the financial statements

The main section of this publication discusses recent comments that concern all registrants. Appendix A highlights trends related to specific industries, and Appendix B provides an overview of the SEC staff's filing review process and best practices for responding to staff comments.

We hope you find this publication helpful. EY professionals are prepared to discuss any concerns or questions you may have.

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Management's discussion and analysis

Results of operations

Summary of issues noted

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

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

Analysis of current issues

Item 303(a)(3) of Regulation S-K provides general instructions for preparing management's discussion and analysis (MD&A) disclosures about the results of operations. The SEC staff often asks registrants to provide a more detailed discussion about their results of operations, including requesting that they:

- ▶ 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 (e.g., significant events that have been disclosed in the press but not disclosed in an SEC filing)
- ▶ Describe any other significant components of revenue or expense necessary to understand the results of operations (such as components of cost of sales)
- ▶ Describe any known trends or uncertainties that have had or are reasonably likely to have a material effect on sales, revenue or income from continuing operations (such as uncertainties arising from tariffs imposed on imports from foreign countries)
- ▶ Discuss how much of any material increase in net sales or revenue is due to business combinations, increased sales volume, introduction of new products or services, or increased sales prices, and quantify each factor's effect, if possible
- ▶ Discuss reportable segment information needed to understand their results of operations, including the effect that the performance of a particular product line may have had
- ▶ Discuss the reasons for a significant change in the effective income tax rate and whether those drivers are expected to affect the future income tax rate (refer to the income taxes section for further discussion)

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

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

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

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

Some of the factors that may cause material period-to-period changes in revenue and operating costs at a registrant's reportable segments include foreign currency fluctuations and changes in the macroeconomic environments around the world. The SEC staff expects registrants to quantify any material effect of such factors on the reportable segment.

The SEC staff has also requested that companies provide forward-looking information about known trends and uncertainties. This information is required for trends and uncertainties that have had or are reasonably likely to have a material effect on revenues or income from continuing operations. In evaluating this requirement, the registrant must determine whether the trend or uncertainty is reasonably likely to occur. If it isn't, no disclosure is required. If the registrant cannot make that determination, it must assume that the trend or uncertainty will occur, and it must disclose that item in MD&A, unless it is not reasonably likely to have a material effect.

When material effects on results of operations are ascribed to an increase (or decrease) in headcount or other internal initiatives (e.g., implementation of a new information technology system), the SEC staff may ask registrants to discuss their expectations about ongoing investments in these initiatives. When registrants discuss changes in laws or regulations, foreign exchange rates or economic conditions (e.g., increasing interest rates), the SEC staff may ask about the expected effects of these items on revenues, income and liquidity in future periods.

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

We note your disclosures regarding the tariff on imports that could adversely affect your costs, supply or have other material adverse impacts on your business. Item 303(a)(iii)(2) of Regulation S-K states that a discussion should be provided of any known trends or uncertainties that you reasonably expect will have a material impact on revenues or income from continuing operations as well as events that will cause a material change in the relationship between costs and revenues. Further, Section III.B.3 of SEC Release No. 33-8350 states that disclosure of a trend, demand, commitment, event or uncertainty is required unless you are able to conclude either that it is not reasonably likely to occur or that a material effect on your liquidity, capital resources or results of operations is not reasonably likely to occur. In this regard, please tell us what consideration you gave to providing additional disclosures in MD&A related to the tariff and its expected impact on your results of operations.

To assess the completeness of MD&A disclosures in a registrant's periodic reports (e.g., Forms 10-K, 10-Q), particularly related to material trends or uncertainties, the SEC staff may also listen to a registrant's earnings calls and read other relevant information (e.g., earnings releases, investor presentations, material contracts filed as exhibits). The SEC staff has often asked registrants to expand their MD&A disclosures when a material trend or uncertainty is not discussed in MD&A, but the entity had addressed it in an earnings release or call.

Example SEC staff comment: Results of operations – expanding MD&A based on a known material trend discussed in earnings release

We note you highlight in your earnings release that 2018 was “Another Year of Significant Cost Reductions.” Please provide a more detailed discussion of the specific components of costs of services in MD&A that management believes can be reduced through the Company's ongoing cost reduction efforts.

Significant components of expense and changes in reserve balances

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

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

Key financial and operating metrics

The SEC staff continues to believe that key financial and operating metrics can be useful for investors to assess operating performance.

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

- ▶ Define the metric, especially when a registrant's definition differs from the definition commonly used in its industry
- ▶ Discuss how the metric is calculated
- ▶ Provide robust disclosures explaining any changes made to the calculation of the metric
- ▶ Discuss any limits on the usefulness of the metric (e.g., individuals may be counted more than once in an “average monthly users” metric)

- ▶ Consider providing information about the metric on a disaggregated basis, such as by segment, geography or revenue stream (e.g., breaking down same-store sales between e-commerce and in-store sales)
- ▶ Clearly explain how the metric or period-to-period change in the metric links to operating results to reveal a trend (e.g., using the increase in the number of customers to explain revenue growth)

To help investors view the registrant through the eyes of management, the SEC's guidance on MD&A suggests that the registrant disclose in MD&A the key performance indicators, financial or nonfinancial, that are used to manage its business. Key performance metrics vary by industry. For example, retail companies use same-store sales and store openings and closings, while social networking and online gaming companies typically focus on the number of monthly or daily users. The SEC staff may ask a registrant to disclose key performance indicators in its SEC filings if the registrant cites the indicator on its website, in a press release, in an investor presentation or in another setting.

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

We note your reference to various metrics in your earnings calls. To the extent that these metrics are used by management to assess the performance of your business, please revise to include disclosure of each of these metrics in future filings or explain. Refer to Section III.B.1 of SEC Release 33-8350.

The SEC staff recognizes the value of using an operating metric 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 is potentially misleading and does not appropriately explain any changes in income statement line items. For example, if a company discloses that it has 10 million total users and expects the number to grow 12%, but doesn't explain that the majority of them are non-paying, investors may incorrectly expect a direct correlation between total user growth and profitability.

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

Your disclosure indicates that the "registered device user metric" is an indicator of the potential size and growth of your paid user community.

To the extent that a prior user of a device continues to be included in this count, please tell us how counting such a user provides an indication of the potential size or growth of your paid user community. Please also explain why this metric represents your potential paid user community when some of the users may not have used your device for an extended period of time.

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[2018 AICPA Conference on Current SEC and PCAOB Developments, *Compendium of significant accounting and reporting issues*](#)

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Critical accounting estimates

Summary of issues noted

The SEC staff's comments have frequently targeted repetitive discussions about critical accounting estimates in MD&A. The SEC staff has reminded registrants that MD&A should supplement but not repeat the disclosures in the significant accounting policies note to the financial statements. The SEC staff often asks registrants to focus their MD&A discussion of critical accounting estimates on the quality and variability of management's most significant judgments and assumptions.

Analysis of current issues

Critical accounting estimates are those that are most important to the financial statement presentation and that require the most difficult, subjective and complex judgments. SEC Financial Release No. 72, *Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations*, (FRR-72) reminds registrants that MD&A rules require disclosure of critical accounting estimates and assumptions when both of the following conditions are met:

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

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

Example SEC staff comment: Duplicative disclosure about critical accounting estimates

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

Please modify the MD&A disclosure to address the specific methods, assumptions and estimates used in your critical accounting estimate. If you prefer to include this disclosure elsewhere in your filing, such as an expanded disclosure in the notes to your financial statements, please consider including a simple cross-reference within your MD&A to avoid repetition.

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

Registrants can consider including in MD&A a cross-reference to the footnote disclosure about significant accounting policies. However, they should expand the MD&A disclosure to (1) address why the accounting estimate or assumption bears the risk of change and (2) analyze the following, if material:

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

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

The SEC staff may request enhancements to the MD&A discussion of specific critical accounting estimates, which we discuss separately in this publication (e.g., measurement of accounts receivable, realizability of deferred tax assets, goodwill impairment).

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Liquidity and capital resources

Summary of issues noted

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

- ▶ Sources and uses of cash and the availability of cash to fund liquidity needs
- ▶ Transparency in the contractual obligations table and its footnotes about interest payments and other items

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

Analysis of current issues

General disclosures

Items 303(a)(1) and (2) of Regulation S-K require that a registrant discuss known material trends, demands, commitments, events or uncertainties that are reasonably likely to affect (either favorably or unfavorably) liquidity or capital resources. For example, if a registrant expects growth in the business from a recently completed acquisition, the SEC staff may ask the registrant to discuss the reasonably likely increase or decrease in liquidity that is expected to be material.

The SEC staff also requests that registrants expand MD&A to include a meaningful analysis and discuss the material components to explain the variability of cash flows. For example, the SEC staff often challenges the discussion about cash flows that recites items that are readily apparent from the statement of cash flows (e.g., changes in working capital) but does not provide analysis about the underlying drivers for material changes.

Example SEC staff comment: Changes in operating cash flows

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

The SEC staff also has requested that registrants disclose:

- ▶ Whether identified trends will continue, and if so, how long they will continue and steps the registrant is taking to address the trends, including plans to remedy any identified material uncertainties or unfavorable trends in short- or long-term liquidity
- ▶ An analysis of all internal and external sources of liquidity, beyond cash on hand, as of the balance sheet date
- ▶ Amounts outstanding and available at the balance sheet date under each source of liquidity, with a comparison to cash needs over the next 12 months, including any significant planned capital expenditures

- ▶ The sufficiency of the amount available under an existing short-term credit arrangement, the anticipated circumstances requiring its use, any uncertainty surrounding the ability to access funds when needed and the implications of not being able to access the arrangement

Example SEC staff comment: Implications of not being able to access capital

We note your disclosure that you will require additional capital in order to meet your ordinary business obligations for the next twelve months. Please revise to disclose how long you expect your business will be able to continue its current and planned operations if you are unable to secure additional capital.

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

Example SEC staff comment: Supplemental disclosures when dealing with elevated risk of debt default

You disclose throughout your filing several instances of debt defaults and covenant violations, waivers of violations and amendments to the terms of your debt agreements, such as the changes made to your revolving credit facility debt covenant ratios disclosed on page XX.

Please revise your MD&A to elaborate on the steps you are taking to avoid a breach of your debt covenants, the impact or reasonably likely impact of a breach on your financial condition or operating performance, and alternate sources of funding to refinance resulting obligations.

Also tell us and disclose whether there are cross default provisions under any of your existing debt obligations and quantitatively disclose the required and actual debt covenant ratios.

When there is a heightened risk of debt default, the SEC staff may request enhanced disclosures about debt covenants and the registrant's compliance with them.

Contractual obligations

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

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

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

The SEC staff has questioned the completeness of items included in registrants' contractual obligations tables and has asked those companies to provide the reasons for excluding certain items from the table. Most notably, the SEC staff has asked companies to include amounts for future interest payments in the contractual obligations table or a footnote to the table, if material. The SEC staff also has asked registrants to disclose reasons why interest on variable debt is not included in their contractual obligations table. When interest rates are variable, registrants should also describe the assumptions that were used to estimate future payments.

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Non-GAAP measures

Summary of issues noted

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

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

Analysis of current issues

The C&DIs provide explicit guidance on uses of non-GAAP measures that the SEC staff believes could be misleading. For example, the staff said in the updated C&DIs that a non-GAAP measure may be considered misleading if it uses an individually tailored recognition or measurement principle or excludes normal, recurring cash operating expenses.

Individually tailored accounting principles

In the C&DIs, the SEC staff clarified that non-GAAP performance measures that accelerate the recognition of revenue or that use other accounting methods not allowed under GAAP may be misleading.

While the SEC staff initially focused on revenue adjustments in performance measures when asking about compliance with this interpretation, it has broadened its approach and challenged other ways registrants modify GAAP recognition and measurement principles to calculate non-GAAP measures. The SEC staff has said in recent speeches that a measure of a registrant's historical or future financial performance, financial position or cash flows may involve tailored accounting principles if it:

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

Significant judgment is required to determine whether a measure meets any of these criteria because the criteria are general and highly subjective. Until the SEC staff provides more clarity, registrants should consider whether they are using measures that the SEC staff has concluded are inappropriate because they involve tailored accounting principles.

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

- ▶ Change the recognition or measurement principles of Accounting Standards Codification (ASC) 606, *Revenue from Contracts with Customers*
- ▶ Eliminate the amortization of only a portion of acquired intangibles
- ▶ Eliminate amortization of intangible assets without a disclosure about how those assets contribute to generating revenue
- ▶ Proportionately consolidate equity method investees
- ▶ Eliminate the provision for loan losses
- ▶ Reflect anticipated future cost savings or synergies in a merger
- ▶ Deconsolidate one or more consolidated subsidiaries

Example SEC staff comment: Eliminating amortization of acquired intangibles

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

Exclusion of normal, recurring cash operating expenses

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

Example SEC staff comment: Exclusion of normal, recurring cash operating expenses

We note that you eliminate public company costs when calculating non-GAAP adjusted EBITDA. Please describe the nature of these costs and explain why these costs are not normal recurring cash operating expenses necessary to operate your business. Refer to Question 100.01 of the Compliance and Disclosure Interpretations on Non-GAAP Financial Measures.

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

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

- ▶ Present the most directly comparable financial measure calculated in accordance with GAAP with equal or greater prominence

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

- ▶ 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 the GAAP measure before the related non-GAAP measure. For this reason, GAAP measures must precede the non-GAAP measures in the required reconciliations. The SEC staff has also objected to registrants presenting a full non-GAAP income statement as a form of reconciliation because this makes the non-GAAP information more prominent.

Example SEC staff comment: Prominence of non-GAAP measures

Item 10(e)(1)(i)(A) of Regulation S-K requires that when a registrant presents a non-GAAP measure it must present the most directly comparable GAAP measure with equal or greater prominence. Please revise your reconciliations of non-GAAP financial measures to begin with the comparable GAAP measure to avoid undue prominence. Refer also to Question 102.10 of the Non-GAAP Financial Measures Compliance & Disclosure Interpretations.

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

If a registrant cannot explain why a measure is useful to investors, or if the SEC staff believes the presentation could be misleading, the SEC staff has asked registrants to expand the disclosure or remove the non-GAAP measure. Additionally, the SEC staff has questioned the usefulness of adjustments that do not appear to be consistent with the purpose of the measure described by the registrant.

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

We note your presentation and reconciliation of adjusted working capital, a non-GAAP measure. Please provide the disclosures concerning how management uses the measure and how the measure is useful to investors, in accordance with paragraph (C) and (D) of Item 10(e)(1)(i) of Regulation S-K.

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

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

Liquidity vs. performance measures

Non-GAAP financial measures may be presented as performance measures, liquidity measures or both. When a registrant uses a non-GAAP measure as both a performance and liquidity measure, the registrant should include separate reconciliations and disclosures for each type of measure. For example, a registrant should reconcile earnings before interest, tax, depreciation and amortization (EBITDA) to both net income and cash flows from operations if EBITDA is presented as both a performance measure and a liquidity measure.

The SEC staff has asked registrants to revise future disclosures to comply with the Regulation S-K requirements for liquidity measures. Registrants cannot present non-GAAP liquidity measures on a per-share basis, and they cannot adjust liquidity measures to remove charges or liabilities that require or will require cash settlement.

Many real estate investment trusts (REITs) disclose Funds from Operations (FFO), a non-GAAP measure of financial performance that is defined by the National Association of Real Estate Investment Trusts (NAREIT). The SEC staff accepts NAREIT's definition of FFO as a performance measure and will not object to the presentation of FFO per share. However, some real estate companies provide modified calculations of FFO, such as "adjusted" FFO (AFFO), "modified" FFO and "core" FFO, and they may use different methods to calculate these measures. The SEC staff may ask management to explain modifications and adjustments to calculations of FFO disclosures and may not accept them as performance measures.

Example SEC staff comment: Non-GAAP liquidity measures

You disclose both that operating income is the most directly comparable GAAP financial measure and that Adjusted Operating Income before Depreciation and Amortization (OIBDA) provides a meaningful representation of operating cash flows. If considered both a performance and a liquidity measure, consolidated Adjusted OIBDA should be reconciled to both net income and operating cash flows, respectively. Refer to Question 102.06 of the Non-GAAP Financial Measures C&DIs.

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[Technical Line, A closer look at the SEC staff's scrutiny of non-GAAP financial measures](#)

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SEC reporting issues

Internal control over financial reporting and disclosure controls and procedures

Summary of issues noted

Internal control over financial reporting (ICFR) continues to be an area of focus of the SEC staff. The SEC staff has questioned the following areas related to ICFR and disclosure controls and procedures:

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

Analysis of current issues

The SEC staff has expressed concerns that material weaknesses are not being identified timely and that control deficiencies are not being evaluated appropriately before a material misstatement occurs. A registrant's conclusion about the severity of a control deficiency depends on its evaluation of both the likelihood and magnitude of an error occurring without being prevented or detected by its ICFR. That is, in making this evaluation, a registrant does not just focus on whether an error requiring correction occurred or how large such an error was.

The SEC staff has said that registrants sometimes focus their interim or annual disclosures related to a material weakness on the accounting error itself rather than whether a control had an ineffective design or failed to operate effectively. In these cases, the SEC staff has asked for additional information on the deficiency, including:

- ▶ The nature and cause of the material weakness (and financial statement error, if applicable)
- ▶ Who identified the material weakness and when it was identified
- ▶ Whether the material weakness affects only certain accounts or processes or is more pervasive
- ▶ The planned actions, costs and timeframe to remedy the material weakness
- ▶ How the registrant compensates for the material weakness to make sure that the financial statements are free from material misstatement
- ▶ The status of any unremediated material weakness that was previously disclosed
- ▶ The effect on disclosure controls and procedures when ICFR is ineffective, given that disclosure controls and procedures include components of ICFR

The SEC staff also has questioned why a registrant's disclosures under Item 308(c) of Regulation S-K did not identify a material change in ICFR during the most recent quarter if a registrant (1) concludes its ICFR and/or disclosure controls and procedures are ineffective due to a new material weakness or (2) reports the remediation of a previously reported material weakness. The SEC staff may question management's judgment when management attributes a material error to a control deficiency but does not conclude that the deficiency is a material weakness.

When correcting an accounting error, management should carefully reassess the implications for its ICFR and disclosure controls and procedures.

Example SEC staff comment: Material weakness

We note in your response that you determined there was a control deficiency in your internal control over financial reporting; however, the deficiency did not rise to the level of a material weakness. A control deficiency constitutes a material weakness if there is a reasonable possibility that a material misstatement of the financial statements would not be prevented or detected in a timely manner.

Based on your determination that the disclosure misstatements in your prior SEC filings were material and a result of a control deficiency, we are unable to agree with your conclusion that the related deficiency is not a material weakness. Please explain how you will address and disclose the ineffectiveness of internal control over financial reporting and disclosure controls and procedures for the periods the material weakness existed.

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

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

If a registrant determines that ICFR or its disclosure controls and procedures (or both) were effective despite the immaterial error correction, the SEC staff may challenge the basis of these conclusions. In particular, the SEC staff often questions the nature of the deficiency that resulted in the error and the likelihood that the deficiency could result in a material misstatement.

Example SEC staff comment: Immaterial error correction and ICFR

Please explain the extent to which you considered the effect of the identified errors on your internal controls and explain how management's conclusion regarding the effectiveness of disclosure controls and procedures, as well as internal control over financial reporting, is appropriate in light of the errors.

To the extent you determined there were control deficiencies that led to the errors, describe in reasonable detail the deficiencies, how you evaluated the severity of each related deficiency and error in your assessment. Please also include in your analysis a description of the maximum potential amount or total of transactions exposed to each related deficiency and explain how you made that determination.

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

Example SEC staff comment: Inappropriate management's assessments

We note your certifying officers concluded your disclosure controls and procedures are effective "subject to the limitations noted above." It is not appropriate to indicate your disclosure controls and procedures are effective subject to certain limitations. You must clearly state whether or not the disclosure controls and procedures are effective. Please amend the Form 10-K to delete the qualification and provide an unqualified conclusion as to the effectiveness of your disclosure controls and procedures.

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

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

Example SEC staff comment: Disclosure controls and procedures and ICFR

You concluded your disclosure controls and procedures (DCP) were effective because management discovered and corrected the errors to ensure the financial statements were prepared in accordance with GAAP. However, please reference the following statement in the fourth paragraph of Sections II.D of SEC Release 33-8238, which states that "disclosure controls and procedures will include those components of internal control over financial reporting that provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles."

Given your conclusion that ICFR was ineffective, which implicates your conclusion regarding DCP per the portion of the SEC Release referenced above, your DCP would also be ineffective even though the errors were identified by management. Please amend to conclude disclosure controls and procedures were ineffective.

EY resources

[2018 SEC annual reports – Form 10-K](#)

[2018 AICPA Conference on Current SEC and PCAOB Developments, *Compendium of significant accounting and reporting issues*](#)

[Financial reporting developments, *Accounting changes and error corrections*](#)

Activities in countries designated as state sponsors of terrorism

Summary of issues noted

The SEC staff may comment on disclosures about liquidity, risk factors and results of operations for registrants with foreign operations or business activities in countries that have been identified by the US Department of State as state sponsors of terrorism. These countries are Syria, Iran, North Korea and Sudan.

In addition to reviewing past filings and correspondence, the SEC staff will search publicly available information (e.g., websites, news articles) for connections to the restricted countries, including comments related to unaffiliated retail locations where a registrant's branded product is sold. If the SEC staff determines that a registrant has any business in one of those countries, the SEC staff will periodically ask for updates on those activities.

Analysis of current issues

While US securities laws do not impose a specific disclosure requirement that addresses business activities in countries other than Iran that are designated as state sponsors of terrorism, Rule 408 of Regulation C and Exchange Act Rule 12b-20 require a registrant to disclose additional information if it is material and necessary to make a company's statements not misleading. Because of these rules, the SEC staff frequently asks registrants to provide the following information and to disclose it if it is material:

- ▶ The nature and extent of past, current and any anticipated operations in or activities with a country designated as a state sponsor of terrorism, whether through subsidiaries, partners, customers, affiliates, joint ventures, distributors, resellers, or other direct or indirect arrangements
- ▶ Any services, products, information and technology provided to and agreements, commercial arrangements and other contracts entered with governments or entities controlled by those governments that are designated as state sponsors of terrorism
- ▶ Whether any of the technologies or materials provided or intended to be provided to a country designated as a state sponsor of terrorism are controlled items included in the US Department of Commerce's Commerce Control List
- ▶ Whether operations in or with state sponsors of terrorism constitute a material risk in quantitative terms by discussing revenues, assets and liabilities associated with such operations and qualitative factors that a reasonable investor would deem important in making an investment decision, including any potential adverse effect on the company's reputation and share value

The only requirement in the federal securities laws is that issuers disclose in their annual and quarterly reports filed with the SEC whether they or their affiliates knowingly engaged in various prohibited activities involving Iran. That requirement was added to the Securities Exchange Act in 2012, as part of the Iran Threat Reduction and Syria Human Rights Act.

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

We note that the website of your subsidiary [X] lists distributors in Syria and Sudan. Syria and Sudan are designated by the State Department as state sponsors of terrorism, and are subject to U.S. economic sanctions and/or export controls. You do not include disclosure about Syria and Sudan in the Form 10-K. Please describe to us the nature and extent of your past, current and anticipated contacts with Syria and Sudan, including contacts with their governments, whether through subsidiaries, distributors, or other direct or indirect arrangements.

Risk factors

Summary of issues noted

The SEC staff has questioned risk factor disclosures that are so general they could apply to any public company. The SEC staff has also questioned the completeness of a registrant's risk factor disclosures, based on information included elsewhere in the filing or in other public information (e.g., an earnings call).

In addition, the SEC staff has recently focused on risks related to cybersecurity, the United Kingdom's withdrawal from the European Union (Brexit) and the expected phase-out of the London Interbank Offered Rate (LIBOR).

Analysis of current issues

Item 105 of Regulation S-K requires a registrant to disclose the significant risks it faces and how it is affected by each of them. Risk factors should be specific to the registrant's facts and circumstances and should not be generic risks that could apply to any registrant.

With the increase in the frequency and severity of cyber attacks and data breaches, cybersecurity continues to be an area of focus. In 2018, the SEC issued an interpretive release to help companies prepare disclosures about cybersecurity risks and incidents. The release includes a framework for registrants to consider when evaluating whether to disclose information about risks and incidents involving cybersecurity. While the framework is similar to the one previously established by the SEC staff in CF Disclosure Guidance: Topic No. 2, it also reminds registrants to consider cyber matters in the context of various policies, such as those for insider trading and selective disclosure (Regulation FD).

Example SEC staff comment: Cybersecurity risk factor

Please revise to provide a description of any cyber incidents that you have experienced that are individually, or in the aggregate, material, including a description of the costs and other consequences, and to provide the investor with an idea of the likelihood that a risk may impact your results and the potential impact on your assets and earnings.

SEC officials have also said that disclosures about the effects of Brexit should be robust and tailored to a company's facts and circumstances, though this hasn't been an area of frequent comment. The United Kingdom is currently scheduled to exit the European Union on 31 October 2019.

The SEC staff has stated in speeches that companies should consider qualitative and quantitative disclosure of Brexit risks, such as:

- ▶ Exposure to new regulatory risk (e.g., uncertainty about applicable laws and regulations and/or transition agreements)
- ▶ Supply chain risks due to the lack of free trade agreements or changes to customs administrations or tariffs on exports and imports
- ▶ Possible loss of customers, decreases in revenues or increases in costs resulting from changes in exchange rates or tariffs

- ▶ Exposure to foreign currency devaluation, exchange rate risk or other market risk
- ▶ Material contracts that may require renegotiation or termination

The SEC staff has also highlighted the potential effects on financial statement recognition, measurement and disclosure items for registrants to consider (e.g., inventory write-downs, long-lived asset impairments, collectibility of receivables, assumptions underlying fair value measurements, foreign currency matters, hedge accounting, income taxes).

Example SEC staff comment: Brexit

Considering your operations in the United Kingdom (“U.K.”) as well as the U.K. pension plan, please tell us what consideration was given to including risk factor disclosure for Brexit.

We expect the SEC to soon begin to scrutinize registrants’ risk factor disclosures pertaining to their transition away from LIBOR, which is expected to be phased out in 2021. The staff of the Division of Corporation Finance said in a statement that it is important for companies to keep investors informed about their progress in managing the transition. Potential disclosures the staff cited include:

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

The SEC staff said the transition could have a significant effect on a registrant’s accounting and financial reporting. Areas the staff highlighted include modifications of debt instrument terms, hedging activities, inputs used in valuation models and potential income tax consequences.

EY resources

[SEC Reporting Update, SEC issues guidance on cybersecurity](#)

[Technical Line, Accounting and reporting considerations for Brexit](#)

[To the Point, FASB proposes relief for the transition away from LIBOR and certain other reference rates](#)

Other SEC reporting issues

Summary of issues noted

The SEC staff has questioned how registrants comply with a number of disclosure requirements in Regulation S-K, Regulation S-X and related guidance.

Analysis of current issues

The staff continues to issue comments requesting compliance with the basic requirements of these rules. While some of these deficiencies may seem inconsequential, registrants may need to amend their filings to demonstrate compliance.

Executive compensation, including Compensation Discussion and Analysis (CD&A)

Registrants should make sure they include all the required disclosures under Item 402 of Regulation S-K and that all the disclosures are up to date. Registrants are encouraged to review our discussion of these requirements, which can be found in Section 5 of our publication, [2019 proxy statements: an overview of the requirements and observations about current practice](#).

Exhibits

When a registrant has discussed significant transactions or agreements in its disclosures, the SEC staff has asked why the related contracts were not filed as exhibits as required by Item 601(b)(10) of Regulation S-K. The SEC staff also has asked registrants to file missing schedules, exhibits or appendices of material contracts (e.g., a credit agreement should include all of its schedules, exhibits and appendices). Registrants often can provide the missing information in a subsequent filing. That is, they don't have to amend the original filing.

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

In future filings, please file all related-party contracts as exhibits, consistent with Item 601(b)(10). If you do not believe that any of these related contracts you reference in your filing are required to be filed, please provide us with that analysis at this time.

Consents and auditors' reports

Item 601 of Regulation S-K requires registrants to file the consents of experts (e.g., auditors) and counsel as exhibits to various forms filed with the SEC. Independent registered public accounting firms must consent to the use of their names and related reports in Securities Act registration statements. The SEC staff has issued comments when these consents (1) aren't included in the filing, (2) omit the signature of the accounting firm or the date of the consent, or (3) refer to the incorrect auditor's report or periods covered by that report.

Example SEC staff comment: Missing consent

It appears your Form 10-K is incorporated by reference into Form S-8 filed XXX. Please tell us why you did not file an auditor's consent related to the use of the audit report. Refer to Item 601(23) of Regulation S-K.

Registrants should make sure that the “Report of Independent Registered Public Accounting Firm” also includes the signature and location of the accounting firm and appropriately identifies all periods and financial statements that have been audited.

Management and the audit committee should also confirm that the auditor has changed its auditor’s report to comply with the Public Company Accounting Oversight Board (PCAOB) standard that requires auditors to include significantly more information in their reports. While certain requirements were effective for periods beginning after 15 December 2017, the requirement to report on critical audit matters is effective for annual periods ending on or after 30 June 2019 for large accelerated filers and 15 December 2020 for all other filers.

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. When preparing officer certifications, registrants should:

- ▶ Follow the form specified by Item 601(b)(31) of Regulation S-K
- ▶ Not include the certifying individual’s title in the first line of the certification
- ▶ Include 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)
- ▶ Include a conformed signature of the signing officer, the officer’s job title and the date the certification was signed at the bottom of the certification

Example SEC staff comment: Section 302 certifications

We note that your certification filed on Exhibit 31.1 does not include the signature of the officer completing the certification, the job title(s) of the officer or the date that the certification was signed. Please file an amended Form 10-K to revise this certification accordingly. Refer to the guidance in Item 601(B)(31) of Regulation S-K.

Form 10-K signatures

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

It's also important that officers sign Form 10-K on behalf of the registrant as well as in their capacity as officers. Officers sometimes incorrectly sign only on behalf of the registrant and not individually, or vice versa.

Example SEC staff comment: Form 10-K signatures

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

Materiality

The SEC staff requests that registrants identify and discuss the quantitative and qualitative factors they considered when they assessed the materiality of error corrections. If a registrant concludes that a large error was immaterial, the SEC staff will challenge that conclusion.

SAB Topic 1.M, which is cited in ASC 250-10-S99-1, includes a list of possible qualitative and quantitative factors that a registrant might consider when assessing how a reasonable investor might consider the materiality of a financial statement item, including a financial statement error. The factors listed in SAB Topic 1.M are not intended to be all inclusive, and each registrant should consider all qualitative and quantitative factors that may be relevant in its circumstances.

Evaluating whether an item is material requires judgment. Both quantitative and qualitative factors should be considered. Registrants must consider qualitative factors especially when the error is small. It is unusual for a registrant to conclude that a large error is not material based on qualitative factors.

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

The SEC staff may question management's judgment when the error has a large effect on certain key measures.

The SEC staff also challenges materiality assessments for "Little r" restatements. Such a restatement occurs when an error is immaterial to the prior year financial statements but correcting the error in the current period would materially misstate the current period financial statements. As a result, the prior year financial statements are restated, even though the revision is immaterial to the results for that year.

When assessing materiality, a registrant should analyze both qualitative and quantitative factors.

In these situations, registrants generally are not required to file an Item 4.02 Form 8-K, *Non-reliance on previously issued financial statements or a related audit report or completed interim review*, or amend prior filings. Instead, they may correct the prior period financial statements, with appropriate disclosure, in the next periodic report that includes the prior period financial statements, as described in SAB Topic 1.N. The SEC staff may request that the registrant provide its materiality assessment so the staff can evaluate whether the method of correcting the error and related reporting are appropriate.

Example SEC staff comment: Materiality

You indicate that you identified errors in previously issued financial statements associated with a subsidiary that were immaterial to each of the prior reporting periods affected. You also indicate that you have revised the prior period results in the current filing since the cumulative effect of correcting the errors in 2018 would materially misstate your 2018 financial results. Please tell us:

- ▶ The analysis of how you determined these errors were both quantitatively and qualitatively immaterial to the current period and all previously reported periods (please refer to SAB Topics 1.M and 1.N when preparing your response)
- ▶ The specific nature of these errors, how and why you believe they occurred, and when and how you discovered them
- ▶ Your consideration of the potential effect of these errors on your conclusions on the effectiveness of your internal controls over financial reporting and disclosure controls and procedures

Financial information of other entities

SEC regulations require registrants to provide financial information about other entities in certain situations, including when they (1) make a significant acquisition of a business (Rule 3-05 and Article 11 of Regulation S-X), (2) have a significant equity method investee (Rules 3-09 and 4-08(g) of Regulation S-X) or (3) are subject to guarantor reporting requirements (Rule 3-10 of Regulation S-X). The financial statement requirements for each rule are based on whether certain thresholds or criteria are met, and each rule has specific requirements about which financial statements or additional information needs to be included in a filing. The SEC staff frequently questions whether registrants have appropriately applied Rules 3-09, 4-08(g) and 3-10 in their annual reports. The SEC staff also asks questions about recently acquired businesses when reviewing an annual report.

The SEC staff frequently requests that a registrant demonstrate that it has appropriately calculated significance or made appropriate disclosures. A registrant should apply the rules strictly unless it has received relief from the SEC staff (see Appendix B). Failure to comply with these requirements can have severe consequences, such as the loss of Form S-3 eligibility.

Example SEC staff comment: Significance tests

It appears that you have not filed historical financial statements pursuant to Rule 3-05 of Regulation S-X. Please submit the analysis you performed to determine that this acquisition was not significant under the investment test, asset test and income test based on the guidance in Rule 3-05 of Regulation S-X, and that you were therefore not required to file historical and pro forma financial statements on Form 8-K related to this acquisition, if this is your view.

Pro forma adjustments

The SEC staff has asked registrants about pro forma financial information disclosed in filings, including registration statements, proxy statements and Forms 8-K. The SEC staff has asked registrants to explain how they have met the requirements of Article 11 of Regulation S-X. The SEC staff also has asked for more transparent disclosure about the calculation of pro forma adjustments.

Example SEC staff comment: Pro forma adjustments

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

Registrants are encouraged to follow rulemaking developments pertaining to financial information of other entities and pro forma adjustments as the SEC has proposed changes to the disclosure requirements in these areas.

EY resources

[2019 proxy statements: an overview of the requirements and observations about current practice](#)

[2018 SEC annual reports – Form 10-K](#)

[To the Point, PCAOB adopts final standard to significantly change the auditor's report](#)

[Financial reporting developments, Accounting changes and error corrections](#)

[2018 AICPA Conference on Current SEC and PCAOB Developments, Compendium of significant accounting and reporting issues](#)

[Financial reporting developments, Equity method investments and joint ventures](#)

[Technical Line, Tips for complying with the SEC reporting requirements for equity method investees](#)

[To the Point, SEC proposes changing disclosure requirements for acquisitions and disposals of businesses](#)

[Pro forma financial information: a guide for applying Article 11 of Regulation S-X](#)

Revenue recognition

ASC 606, Revenue from Contracts with Customers, and ASC 340-40, Other Assets and Deferred Costs – Contracts with Customers

Overview

In its first year of reviewing how a wide range of registrants applied the new revenue standard and related cost guidance, the SEC staff's comments have focused on areas of judgment (e.g., identifying performance obligations, determining timing of satisfaction of performance obligations, estimating variable consideration, determining the amortization period of capitalized contract costs). The SEC staff has asked registrants to further explain and sometimes provide their analysis for certain judgments and estimates made in their application of the standards.

Based on what we have seen, registrants appear to have been able to resolve these comments in the same manner as comments on other topics. That is, the registrants have helped the staff gain a better understanding of the judgments made by management or provided additional disclosures in future filings. Contemporaneous documentation of the judgments made in applying ASC 606 and ASC 340-40 will help facilitate the dialogue with the SEC staff during the comment process.

ASC 606 and ASC 340-40 became effective for public entities, as defined, for fiscal years beginning after 15 December 2017 and for interim periods therein. This section focuses on the comments issued by the staff for these standards and highlights emerging topics.

EY resources

[Financial reporting developments, Revenue from contracts with customers \(ASC 606\)](#)

Identifying performance obligations

The SEC staff has asked registrants how they determined their performance obligations in contracts with customers.

Summary of issues noted

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

Analysis of current issues

To apply ASC 606, an entity must first identify the promised goods and services within 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 within the context of the contract). If a promised good or service does not meet these criteria, it is required to be combined with other promised goods or services until a distinct bundle of goods or services exists.

The SEC staff has requested that registrants provide an analysis supporting their determination that certain promised goods or services in a contract were not separately identifiable from other promises in the contract and, therefore, were not distinct performance obligations.

In other cases, the SEC staff has requested that registrants provide a similar analysis to support their determination that certain promised goods or services in a contract were separately identifiable from other promises in the contract and, therefore, were distinct performance obligations.

Example SEC staff comment: Identifying performance obligations

You disclose that "many" of your contracts have a single performance obligation. Please help us understand the nature of the goods and services transferred in these contracts and provide us with your analysis regarding how you determined that the goods and services in these contracts should be combined. Refer to ASC 606-10-25-19 through 22.

Registrants should carefully identify the promises in a contract and evaluate the criteria for determining whether the promised 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), which may require significant judgment. ASC 606-10-25-21 includes three factors that are intended to help entities determine when the promises in a bundle of promised goods or services are not separately identifiable and, therefore, should be combined into a single performance obligation: (1) the presence of a significant integration service, (2) the presence of significant modification or customization or (3) the promised goods or services are highly interdependent or highly interrelated.

The third factor is often the most difficult for entities to assess. Promised goods or services are highly interdependent or highly interrelated if each of the promised goods or services is *significantly* affected by one or more of the other goods in the contract. That is, an entity needs to evaluate whether there is a significant two-way dependency between the promised goods and services. Thorough and contemporaneous documentation of this analysis is critical to determine the performance obligations (i.e., the unit of account for revenue recognition) in a contract with a customer.

Registrants should review their disclosures to verify that they meet the requirement of ASC 606-10-50-12(c), which states that an entity shall disclose information about its performance obligations in contracts with customers, including a description of the nature of the goods or services that the entity has promised to transfer.

EY resources

[Financial reporting developments, Revenue from contracts with customers \(ASC 606\)](#)

Principal vs. agent considerations

Summary of issues noted

The SEC staff has asked registrants how they determine whether they are a principal or an agent in contracts with customers. In particular, the SEC staff is interested in the nature of the goods or services being provided to the customer and what the registrant's role is in providing the good or service to the customer.

Analysis of current issues

When more than one party is involved in providing goods or services to a customer, ASC 606 requires an entity to determine whether it is a principal or an agent in these transactions by evaluating the nature of its promise to the customer. An entity is a principal and, therefore, records revenue on a gross basis if it controls a promised good or service before transferring that good or service to the customer. Alternatively, an entity is an agent and records as revenue the net amount it retains for its agency services if its role is to arrange for another entity to provide the goods or services.

Under ASC 606-10-55-36A, an entity must first identify the specified good or service (or unit of accounting for the principal vs. agent evaluation) to be provided to the customer in the contract in order to determine the nature of its promise (i.e., whether it is to provide the specified goods or services or to arrange for those goods or services to be provided by another party). The entity then must determine whether it controls the specified good or service before transfer to the customer in accordance with the definition of control under ASC 606-10-25-25.

Because it may not be clear whether an entity controls the specified good or service before it is transferred to the customer, the standard provides three indicators of when an entity controls the specified good or service and is therefore a principal: (1) the entity is primarily responsible for fulfilling the promise to provide the specified good or service to the customer, (2) the entity has inventory risk before the specified good or service has been transferred to a customer or after transfer of control to the customer and (3) the entity has discretion in establishing the price for the specified good or service.

The SEC staff has requested that registrants provide an analysis supporting their determination of whether they are a principal or an agent in contracts with customers, including details of the nature of the goods or services being provided to the customer.

Example SEC staff comment: Principal vs. agent considerations

We note your disclosure that when more than one party is involved in providing services to a customer, you generally act as the principal and report revenue on a gross basis. Please tell us which arrangements involve third parties and tell us how you determined you control each service before it is transferred to the customer. In addition, we note your disclosure on page 51 regarding agent commissions. Please help us understand the nature of these agent services. Reference ASC 606-10-55-36 through 40. ASC 606-10-50-12(c) requires entities to disclose the nature of the goods or services that they have promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services (i.e., if the entity is acting as an agent).

Entities may need to apply significant judgment to determine whether they are a principal or an agent in contracts with customers. Entities should carefully examine their contracts and any terms that may influence the assessment of control.

EY resources

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

Variable consideration

Summary of issues noted

The SEC staff has asked registrants how they estimate variable consideration when determining the transaction price in contracts with customers. In particular, the SEC staff is interested in how registrants estimated different forms of variable consideration, including how they applied the constraint.

Analysis of current issues

ASC 606 describes variable consideration broadly to include discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses and penalties. Variable consideration can result from explicit terms in a contract or can be implied by an entity's past business practices or intentions under the contract.

An entity is required to estimate variable consideration using either an "expected value" or the "most likely amount" method. An entity should choose the expected value method or the most likely amount method based on which method better predicts the amount of consideration to which it will be entitled. That is, the method selected is not meant to be a free choice. Rather, an entity selects the method based on the specific facts and circumstances of the contract.

Before it can include any amount of variable consideration in the transaction price, an entity must consider whether the amount of variable consideration is required to be constrained. That is, to include variable consideration in the estimated transaction price, the entity has to conclude that it is probable that a significant reversal of cumulative revenue recognized will not occur in future periods once the uncertainty related to the variable consideration is resolved. When the uncertainty is significant, entities should not default to constraining the estimate of variable consideration to zero. An entity needs to consider both the likelihood and magnitude of a revenue reversal to apply the constraint, and it should carefully evaluate the factors that could increase the likelihood or the magnitude of a revenue reversal, including these listed in the standard:

- ▶ The amount of consideration is highly susceptible to factors outside the entity's influence (e.g., volatility in a market, judgment or actions of third parties, weather conditions, high risk of obsolescence of the promised good or service).
- ▶ The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.
- ▶ The entity's experience (or other evidence) with similar types of contracts is limited, or that experience (or other evidence) has limited predictive value.
- ▶ The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.
- ▶ The contract has a large number and broad range of possible consideration amounts.

The SEC staff has asked registrants how they estimated variable consideration in contracts with customers.

The SEC staff has requested that registrants explain the different forms of variable consideration included in their contracts with customers, how they estimated the variable consideration and whether the estimates were constrained.

Example SEC staff comment: Variable consideration

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

ASC 606-10-50-12(b) requires entities to disclose significant payment terms of their performance obligations in contracts with customers (e.g., whether the consideration amount is variable, whether the estimate of variable consideration is typically constrained). ASC 606-10-50-20(a) and 50-20(b) also require entities to disclose information about the methods, inputs and assumptions used to estimate variable consideration and to determine whether the estimate should be constrained. The SEC staff has commented when registrants have not included these disclosures.

Registrants should carefully consider and identify all forms of variable consideration when they determine the transaction price for their customer contracts and review their disclosures to verify that they meet the requirements of ASC 606-10-50-12 and 50-20.

EY resources

[Financial reporting developments, Revenue from contracts with customers \(ASC 606\)](#)

Residual allocation approach

Summary of issues noted

The SEC staff has asked registrants to explain how they met the criteria to apply the residual approach to estimate the standalone selling price of a promised good or service under ASC 606. In particular, the SEC staff has asked registrants for a comprehensive, quantitative analysis to support their conclusion that their pricing for a good or service is highly variable or uncertain.

Analysis of current issues

Once an entity has identified the separate performance obligations in a contract with a customer and determined the transaction price, ASC 606 generally requires the entity to allocate the transaction price to the performance obligations in proportion to their standalone selling prices (i.e., on a relative standalone selling price basis). In order to do this, an entity must first determine the standalone selling price of the distinct good or service underlying each performance obligation. The standard includes three possible estimation approaches: (1) the adjusted market assessment approach, (2) the expected cost plus a margin approach and (3) a residual approach. However, any reasonable estimation approach is permitted, as long as it is consistent with the notion of a standalone selling price, maximizes the use of observable inputs and is applied on a consistent basis for similar goods and services.

The residual approach allows an entity to estimate the standalone selling price of a promised good or service as the difference between the total transaction price and the observable (i.e., not estimated) standalone selling prices of other promised goods or services in the contract, provided one of two criteria in ASC 606-10-32-34(c) are met: (1) the entity sells the same good or service to different customers (at or near the same time) for a broad range of amounts (i.e., the selling price is highly variable because a representative standalone selling price is not discernible from past transactions or observable evidence) or (2) the entity has not yet established a price for that good or service, and the good or service has not previously been sold on a standalone basis (i.e., the selling price is uncertain).

The SEC staff has requested that registrants provide a comprehensive, quantitative analysis supporting their determination that they met one of these criteria to apply the residual approach.

Example SEC staff comment: Use of the residual method

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

Before an entity determines that it can apply the residual approach, it must maximize the use of whatever observable inputs it has available to make its estimate. An entity should consider all factors contemplated in negotiating the contract with the customer and the entity's normal pricing practices factoring in the most objective and reliable information that is available.

Further, the use of the residual approach cannot result in a standalone selling price of zero (or close to zero) if the good or service is distinct. This is because a distinct good or service must have value on a standalone basis. We anticipate that the use of the residual approach likely will be limited because it can be applied only when the selling price of one or more goods or services is unknown, either because the historical selling price is highly variable or because the goods or services have not yet been sold. An entity considering using the residual approach should perform a thorough, quantitative analysis to support its determination that the use of the residual approach is appropriate.

EY resources

[Financial reporting developments, Revenue from contracts with customers \(ASC 606\)](#)

Satisfaction of performance obligations

Summary of issues noted

The SEC staff has asked registrants to clarify whether performance obligations are satisfied over time or at a point in time and why the method they used to measure progress toward satisfaction of an over-time performance obligation provides a faithful depiction of the transfer of goods or services in a contract with a customer.

Analysis of current issues

ASC 606 states that an entity must determine at contract inception whether it will transfer control of a promised good or service over time. An entity transfers control of a good or service over time if one of the following criteria are met: (1) the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs, (2) the entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced or (3) the entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date. If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time.

ASC 606-10-50-12(a) requires entities to disclose when the entity typically satisfies its performance obligations (e.g., upon shipment, as services are delivered), and ASC 606-10-50-17(a) requires entities to disclose significant judgments made in determining the timing of satisfaction of performance obligations. The SEC staff has commented when registrants have not included these disclosures or identified which performance obligations are satisfied at a point in time rather than over time.

Example SEC staff comment: Satisfaction of performance obligations

We note your disclosure that service revenues are recognized at a point in time, as transactions are processed, or over a period of time, typically one month or less. Please explain to us and revise your disclosure in future filings to identify which method applies to each of the five ways you list as earning service revenue. See ASC 606-10-50-17.

When an entity has determined that a performance obligation is satisfied over time, ASC 606 requires the entity to select a single revenue recognition method (i.e., measure of progress) that depicts the entity's performance in transferring control of the goods or services. The standard provides two methods for measuring progress: (1) input methods (e.g., resources consumed, labor hours expended, costs incurred, time elapsed, machine hours used) and (2) output methods (e.g., surveys of performance completed to date, appraisals of results achieved, milestones reached, time elapsed, units produced or units delivered).

ASC 606-10-50-18 requires entities to disclose the method used to recognize revenue (e.g., a description of the input or output methods used and how those methods are applied) and why the method selected provides a faithful depiction of the transfer of goods or services. The SEC staff has commented when registrants have not included these disclosures.

Example SEC staff comment: Satisfaction of performance obligations

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

Registrants should review their disclosures to verify that they meet the specific requirements of ASC 606-10-50-12(a), 50-17(a) and 50-18.

EY resources

[Financial reporting developments, Revenue from contracts with customers \(ASC 606\)](#)

Disaggregated revenue disclosures

The SEC staff has asked about registrants' disaggregated revenue disclosures and how they determined categories for disaggregation.

Summary of issues noted

The SEC staff has asked about registrants' disaggregated revenue disclosures and how the categories for disaggregation were determined in accordance with the disclosure requirements in ASC 606.

Analysis of current issues

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.

The implementation guidance in ASC 606-10-55-89 through 55-91 indicates that the most appropriate categories for a particular entity depend on its facts and circumstances, but an entity should consider how it disaggregates revenue in other communications (e.g., press releases, information regularly reviewed by the chief operating decision maker (CODM) for evaluating the financial performance of operating segments) when determining which categories are most relevant and useful.

While ASC 606 does not specify how revenue should be disaggregated, the implementation guidance suggests categories for entities to consider. Example categories include, but are not limited to, the following:

- ▶ Type of good or service (e.g., major product lines)
- ▶ Geographical region (e.g., country, region)
- ▶ Market or type of customer (e.g., government customers, nongovernment customers)
- ▶ Type of contract (e.g., fixed-price contracts, time-and-materials contracts)
- ▶ Contract duration (e.g., short-term contracts, long-term contracts)
- ▶ Timing of transfer of goods or services (i.e., at a point in time or over time)
- ▶ Sales channels (e.g., goods sold directly to consumers, goods sold through intermediaries)

The SEC staff has requested that registrants explain how they considered the implementation guidance in ASC 606-10-55-89 through 55-91 when selecting the appropriate categories to disaggregate revenue. Specifically, the SEC staff would like to understand how the registrant's disclosures meet the objective of depicting how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors. Similar to how it reviews segment disclosures, the SEC staff may review all publicly available information to evaluate whether the objectives of this disclosure requirement have been met. The SEC staff has commented when registrants have not disaggregated revenue in a manner similar to how they have disclosed information in other communications.

Example SEC staff comment: Disaggregated revenue disclosures

We note your disaggregated revenue disclosures by product and by geographic region in Note XX. With respect to the disclosure requirements of ASC 606-10-50-5, please tell us how you considered the guidance in paragraphs ASC 606-10-55-89 through 55-91 for disclosing further disaggregation of revenue for other products similar to the table disclosed on page XX and in your earnings releases furnished on Form 8-K. Please tell us why you believe your current disclosures meet the objective of depicting how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors.

We believe that when determining categories for disaggregation of revenue, registrants should analyze specific risk factors for each of their revenue streams to determine the proper level of revenue disaggregation that will be beneficial to users of the 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. Registrants should also consider how information about their revenue has been presented for other purposes, including disclosures presented outside the financial statements, information regularly reviewed by the CODM and other similar information used by the entity or users of the financial statements to evaluate the entity's financial performance or to make resource allocation decisions.

In addition, an entity is required by ASC 606-10-50-6 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.

EY resources

[Financial reporting developments, Revenue from contracts with customers \(ASC 606\)](#)

Amortization of capitalized contract costs

The SEC staff has asked registrants to explain how they determined the amortization period for contract costs capitalized under ASC 340-40.

Summary of issues noted

The SEC staff has asked registrants to explain how they determined the amortization period for contract costs capitalized under ASC 340-40. In particular, the SEC staff asks for more information about costs to obtain a contract with a customer, including how renewal sales commissions (if any) are considered in the amortization period determination.

Analysis of current issues

Under ASC 340-40, the incremental costs of obtaining a contract with a customer (e.g., sales commissions) are recognized as an asset if the entity expects to recover those costs. Any capitalized contract costs are amortized over a period that is consistent with the transfer to the customer of the related goods or services. This can also be thought of as the expected period of benefit of the asset capitalized that likely would extend beyond the contract term if the capitalized contract costs relate to goods or services being transferred under multiple contracts or to a specific anticipated contract (e.g., certain contract renewals).

When evaluating whether the amortization period for an initial sales commission extends beyond the original contract period, an entity should evaluate whether an additional commission is paid for any expected renewals and, if so, whether the renewal commission is “commensurate” with the original commission (i.e., reasonably proportional to the contract values). For example, a 6% commission on an initial contract and a 2% commission on a renewal would not be commensurate. If the entity’s past experience indicates that a renewal is likely, the amortization period would be longer than the initial term if the renewal commission is not commensurate with the initial commission.

When the expected period of benefit extends beyond the initial contract term, it may be the expected customer relationship period, but that is not always the case. To determine the appropriate amortization period, an entity needs to evaluate the type of capitalized costs, what the costs relate to and the specific facts and circumstances of the arrangement.

When evaluating the appropriate amortization period for renewal commissions, an entity would also consider whether additional commissions are expected for further renewals and whether those commissions would be commensurate. For example, if an entity expects to renew an annual contract in years two through four and pay a 2% commission upon each renewal, each renewal commission would be considered commensurate, and the appropriate amortization period for each renewal commission would likely be one year.

The SEC staff has requested that registrants provide more information about capitalized costs to obtain a contract with a customer. Specifically, the SEC staff has asked whether additional sales commissions are paid for contract renewals, if those renewal commissions are commensurate with the initial commissions and how expected renewals are considered when determining the amortization period for commissions capitalized under ASC 340-40. In addition, the staff has asked about how renewal commissions are amortized. The SEC staff also asks registrants to include such information in their disclosures in accordance with ASC 340-40-50-2(b).

Example SEC staff comment: Amortization of capitalized contract costs

Please tell us, and revise to clarify, whether sales commissions paid upon contract renewals are commensurate with the initial commissions and disclose how commissions paid for renewals are considered in the eight-year amortization period for the initial commission. You also disclose that renewals are amortized over 18 months. Please tell us whether this exceeds the term of the respective customer contract and, if so, explain how your policy complies with ASC 340-40-35-1. Lastly, please tell us how you determined the four-year amortization period for add-ons. Refer to ASC 340-40-50-2(b).

In determining the appropriate amortization period or the period of benefit for capitalized contract costs, the entity should consider its facts and circumstances and may use similar judgment to that used when estimating the amortization period for intangible assets (e.g., a customer relationship intangible acquired in a business combination). This could include considering factors such as customer “stickiness” and how quickly the entity’s products and services change. It is important for registrants to document the judgments they make when determining the appropriate amortization period.

ASC 340-40 requires disclosure of judgments made in determining the amounts of costs that are capitalized, the amortization method chosen and other quantitative disclosures. Registrants should review their disclosures to verify that they meet the requirements in ASC 340-40-50-2(b).

EY resources

[Financial reporting developments, Revenue from contracts with customers \(ASC 606\)](#)

Business combinations

Business combinations disclosure

The SEC staff has asked registrants to explain why a group of assets acquired did not constitute a business.

Summary of issues noted

The SEC staff has asked registrants to enhance or explain their disclosures about business combinations by:

- ▶ Presenting all of the disclosures required by ASC 805, including the pro forma information required by ASC 805-10-50-2(h)
- ▶ Providing the SEC staff with information about how they identified and determined the fair value of acquired intangible assets, especially when goodwill was a substantial portion of the consideration transferred
- ▶ Explaining how they evaluated whether the acquired set of assets and activities constituted a business or an asset

Analysis of current issues

General disclosures

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

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

The SEC staff has questioned whether registrants' disclosures about business combinations are sufficient and requested that registrants expand their disclosures to provide material information required by ASC 805.

Example SEC staff comment: General disclosures

Please address the following:

- ▶ Provide a table in the footnotes for the fair value of the major classes of assets acquired and liabilities assumed. As part of this presentation, please separately present each major class of property, plant and equipment and identifiable intangible assets acquired. Refer to ASC 805-20-50-1.
- ▶ Please tell us where you disclosed the primary reasons for the acquisition as required by ASC 805-10-50-2(d). If this disclosure was not provided, please provide it in your upcoming filing.

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 specifics in their 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.

Example SEC staff comment: Disclosures relating to goodwill recognized

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

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 to explain 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 Article 11 pro forma financial information.

Example SEC staff comment: Pro forma disclosures

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

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

Identification and valuation of acquired intangible assets

The SEC staff has challenged whether additional intangible assets should have been recognized in a business combination and whether the valuation of an acquired intangible asset is appropriate. This is often the case when registrants have allocated a significant portion of the purchase price to goodwill. For further discussion, please refer to the *Intangible assets* section of this publication.

Determination of business or asset acquisition

When a registrant's disclosure about the acquired assets and activities is unclear, the SEC staff has asked registrants to explain how they evaluated whether the acquired set constitutes a business or an asset. Specifically, the staff has asked how registrants determined that "substantially all" of the acquired assets are concentrated in a single asset or a group of similar identifiable assets and, therefore, are not a business. In addition, the SEC staff may request that registrants explain whether the acquired set meets the minimum requirements to be a business.

Example SEC staff comment: Determination of a business or asset acquisition

Please provide us your analysis underlying your conclusion that the set of assets and liabilities acquired did not constitute a business. Citing the guidance in paragraphs 805-10-55-3A through 55-6 and 805-10-55-8 through 55-9, please address:

- ▶ How you determined that substantially all of the acquisition is made up of one asset or several similar assets
- ▶ Whether the set of assets include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs. In this regard, refer to paragraphs 5D and 5E of ASC 805-10-55.

EY resources

Financial reporting developments, *Business combinations*

Goodwill

Impairment analysis and disclosures

The SEC staff has requested additional disclosures on reporting units at risk of impairment.

Summary of issues noted

The SEC staff has requested additional information about goodwill, including:

- ▶ Disclosures about reporting units that may be at risk of goodwill impairment and the timing of impairment losses
- ▶ Information about the registrant's impairment testing policies
- ▶ Disclosure of goodwill impairment testing policies

Analysis of current issues

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. To assist registrants in meeting this disclosure obligation, the SEC staff lists disclosures in Financial Reporting Manual (FRM) Section 9510.3 that registrants should consider providing when any reporting unit's estimated fair value does not substantially exceed its carrying value (i.e., the reporting unit is at risk of failing a future impairment test under ASC 350). The SEC staff often makes this request when the registrant's operating results (or those of the relevant segment) have declined significantly.

Example SEC staff comment: Reporting units at risk of impairment

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

- ▶ Identity of the reporting unit
- ▶ The percentage by which fair value exceeds the carrying value as of the most recent impairment test
- ▶ The amount of goodwill
- ▶ A description of the methods and key assumptions used to determine the estimated fair value and how the key assumptions were determined
- ▶ A discussion of the degree of uncertainty associated with the key assumptions
- ▶ A discussion of any potential events and/or circumstances that could have a negative effect on the estimated fair value

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 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 highlighted the importance of disclosing the percentage by which the fair value exceeded the carrying value of reporting units that are at risk of impairment as of the most recent goodwill impairment test.

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

Information on impairment analysis

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

- ▶ Details of the goodwill impairment analysis for each reporting unit, including how reporting units are identified and how assets, liabilities and goodwill are assigned to reporting units
- ▶ Sensitivity analyses regarding material assumptions used in testing goodwill for impairment, including qualitative and quantitative factors, and how changes in those assumptions might affect the outcome of the goodwill impairment test
- ▶ The reconciliation of the aggregate fair values of the reporting units to the registrant's market capitalization and justification of the implied control premium, including relevant transactions reviewed to support the control premium
- ▶ Details of the registrant's analysis of events that have occurred since the latest annual goodwill impairment assessment and whether those events are indicators of impairment that require an interim goodwill impairment assessment
- ▶ The reasons for and the result of any goodwill impairment test, even if no impairment was recognized
- ▶ The type of events that could lead to a future goodwill impairment

The SEC staff also has asked registrants whether they performed interim impairment tests when publicly available information indicated that such a test may have been necessary (e.g., the company's market capitalization declined, the company reduced prices, the company faced more competition). If the registrant didn't perform a test, the SEC staff has requested an explanation. The staff has also challenged the results of interim impairment testing.

The SEC staff has asked registrants to disclose additional information about their impairment analyses in critical accounting estimates in MD&A after reviewing the information provided.

Disclosure of accounting estimates

The SEC staff has asked registrants to provide robust disclosures in their critical accounting estimates section in MD&A about assessing goodwill for impairment and has frequently requested additional information about the facts and circumstances leading to any recognized goodwill impairment. These requests often focus on:

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

Example SEC staff comment: Factors that could lead to a future impairment

Please expand your disclosures to discuss any material uncertainties, such as operational, economic and competitive factors specific to the key assumptions underlying the fair value estimate used in your impairment testing that have a reasonable possibility of changing and could lead to additional material goodwill impairment charges in the future.

EY resources

Financial reporting developments, Intangibles – goodwill and other

Intangible assets

Recognition, measurement, amortization and impairment

Summary of issues noted

The SEC staff has requested that registrants provide the following details about their intangible asset disclosures:

- ▶ Information about intangible assets recognized as part of a business combination
- ▶ An explanation of how the assets' useful lives were determined, and for finite-lived intangible assets (e.g., customer relationships), the factors leading to the amortization method selected
- ▶ Supplemental information on how intangible assets were assessed for impairment

After reviewing this information, the SEC staff has asked registrants to enhance or revise their intangible asset disclosures.

Analysis of current issues

Intangible assets recognized in a business combination

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

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

Useful life determination – indefinite-lived intangible assets

When determining the useful life of an intangible asset, a registrant should consider the period over which the asset is expected to contribute directly or indirectly to its future cash flows. Registrants should consider all of the factors listed in ASC 350 and all other relevant information when determining the useful lives of intangible assets.

The SEC staff has asked how a registrant has considered its own historical experience in renewing or extending similar arrangements (consistent with the intended use of the asset by the registrant). A registrant should consider its own historical experience even if similar arrangements did not have explicit renewal or extension provisions.

A registrant should consider the useful life of an intangible asset to be indefinite only after considering all relevant facts and determining that there are no legal, regulatory, contractual, competitive, economic or other factors that limit the useful life of the intangible asset. An indefinite-lived intangible asset must be evaluated each reporting period to determine whether events and circumstances continue to support an indefinite useful life. The SEC staff also has challenged a registrant's assertions that intangible assets have an indefinite life and has asked registrants to explain the factors they considered when making this determination.

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

Tell us how you determined that the acquired intangible assets from your acquisition of ABC Company were deemed to have an indefinite useful life. In your response, please tell us why you believe that no legal, regulatory, contractual, competitive, economic, expected use or other factors could limit the useful life of these intangible assets. We refer you to ASC 350-30-35-1 through 4.

Useful life determination and amortization method – finite-lived intangible assets

The SEC staff focuses on the useful life and amortization method of acquired finite-lived intangible assets (e.g., trade names, customer lists, customer contracts, 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 also has 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

Please help us better understand how you determined the 15-year period over which the acquired customer relationships are expected to contribute directly or indirectly to your future cash flows. Tell us in more detail about the attrition analysis of the customer relationships acquired, including, but not limited to, the historical length of those relationships and rates of attrition. Also tell us how contractual renewals and other extensions were considered in your analysis. Describe your own historical experience renewing or extending similar arrangements and how it affected your analysis and what, if any, market participant assumptions were considered and incorporated into your conclusion. In this regard, we note from your disclosures that the useful lives of customer relationships acquired in prior periods range from five to ten years for the fiscal year ended 31 December and that most of your contracts have terms ranging from three to five years, including renewal terms at the option of the customer.

The SEC staff has challenged whether impairments of indefinite-lived intangibles should be recognized if a registrant's market capitalization or operating results (or the operating results of the relevant segment) have declined significantly.

Example SEC staff comment: Amortization method – finite-lived intangible assets

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

Supplemental information on impairment analysis

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

When a goodwill or long-lived asset impairment charge has been incurred, the SEC staff has requested an explanation of how the registrant considered the factors that led to impairment in evaluating the need for an impairment test of other finite-lived intangible assets in the period. Additionally, if a registrant doesn't record an impairment charge when other companies in the same industry or market are experiencing an economic downturn and recognizing impairment charges, the SEC staff is more likely to request an explanation for that conclusion.

EY resources

[Financial reporting developments, *Intangibles – goodwill and other*](#)

[Financial reporting developments, *Business combinations*](#)

Consolidation

Variable interest entity consolidation, noncontrolling interests and disclosures

The SEC staff expects registrants to avoid boilerplate disclosures about their consolidation conclusions.

Summary of issues noted

The SEC staff has asked registrants to:

- ▶ Explain how they determined whether an entity is a variable interest entity (VIE), including how they evaluated details of the arrangement and the registrants' involvement with the entity
- ▶ Explain how they determined whether they were or were not the primary beneficiary of a VIE
- ▶ Provide additional details related to their noncontrolling interests, including their computation of ownership interests and net income or loss attributable to their noncontrolling interests
- ▶ Provide enhanced disclosures about their consolidation accounting policy and how they determined whether they have controlling financial interests

Analysis of current issues

Primary beneficiary determination

The SEC staff has asked registrants to provide supplemental information about their primary beneficiary determination, focusing particularly on the decisions about the activities that most significantly impact the VIE's economic performance.

Example SEC staff comment: Primary beneficiary determination

We note from your disclosure that Entity A is determined to be a VIE which you do not consolidate based on the conclusion that you are not the primary beneficiary. Please provide us with your detailed analysis explaining to us how you determined that you are not the primary beneficiary. Please cite the applicable guidance in your response.

Income and losses attributable to noncontrolling interests

The SEC staff has asked registrants to explain how they determine income and losses attributable to noncontrolling interests. In certain cases, the SEC staff has requested calculations to support such attribution.

Example SEC staff comment: Income and losses attributable to noncontrolling interests

Provide us with further detail to support the allocation of net income (loss) attributable to the noncontrolling interests.

Disclosures

The SEC staff continues to remind registrants that ASC 810-10-50-2AA requires disclosure of qualitative and quantitative information about involvement with a VIE, including, but not limited to, the nature, purpose, size, risks and activities of the VIE and the significant judgments and assumptions made in determining whether they must consolidate a VIE. ASC 810-10-50-2AA(d) also requires registrants to disclose how their involvement with a VIE affects their financial position, financial performance and cash flows.

Example SEC staff comment: Disclosures

It appears based on your disclosure that most of your operations stem from the consolidation of your VIE, Entity A. As such, please expand your disclosure to include the disclosures required by ASC 810-10-50-2AA(b) and (c). Also, in accordance with ASC 810-10-50-2AA(d), disclose how your involvement with your VIEs affects your cash flows.

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

EY resources

Financial reporting developments, Consolidation: determination of a controlling financial interest and accounting for changes in ownership interests

Segment reporting

Identification and aggregation of operating segments, disclosures and internal control over financial reporting

Summary of issues noted

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

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

Analysis of current issues

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

The SEC staff has emphasized the importance of ICFR, including whether the design and operation of internal controls over a registrant's segment reporting judgments are appropriate. Input from, and interaction with, the CODM may be an important element in the design of effective ICFR, and specifically how the CODM allocates resources and assesses performance.

The SEC staff also has reminded registrants that documenting the design and effective operation of management's controls over its judgments is an integral part of management's support for the effectiveness of its ICFR and is essential to the auditor's ability to evaluate these controls.

When reviewing segment reporting, the SEC staff considers information within 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.

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

The SEC staff continues to challenge assessments made under ASC 280.

While the SEC staff has historically commented on segment reporting, we continue to see considerable focus in this area, even when the SEC staff has previously commented on a registrant's segment reporting. Questions on segment reporting have often resulted in multiple rounds of comments, particularly when the registrant's initial response was not comprehensive. The review process also has led to requests for a teleconference with the SEC staff, including representatives of the SEC's Office of the Chief Accountant.

Identification of operating segments

The segment reporting guidance is based on a "management approach" (ASC 280-10-5). That is, segment disclosures should be consistent with a registrant's internal management reporting structure to enable investors to view the registrant similarly to the way management does. Registrants should challenge any conclusions they reach on operating segments that are not consistent with the basic organizational structure of their operations. To support the management approach concept, the SEC staff 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 50-9) is the first step in preparing segment disclosures. A critical element of this analysis is identifying the CODM. Under ASC 280, the CODM is a function, not necessarily a manager with a specific title. The SEC staff has said that a registrant should focus on who makes the key operating decisions in the organization and not default to who makes the strategic decisions or has the ultimate decision-making authority. That is, the registrant should not default to the chief executive officer or the chief operating officer when determining the CODM, and the registrant's ICFR should clearly identify and assess those responsible for the key operating decisions that are necessary to run the business.

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 allows the SEC staff to challenge whether the identified operating segments are consistent with how the CODM assesses performance and allocates resources.

To qualify as an operating segment, a component must have discrete financial information available that the CODM uses to assess performance and make resource allocation decisions. This financial information must be sufficiently detailed to allow the CODM to make decisions. When determining whether discrete financial information is available, the SEC staff has cautioned that a registrant shouldn't conclude that discrete financial information is not available simply because certain costs are shared and not allocated specifically to each component. Gross profit information or other operating measures provided to the CODM and used to assess performance and make resource allocation decisions could be considered discrete financial information.

The SEC staff frequently has requested that registrants describe the financial information provided to the CODM so the SEC staff can understand the information used by the CODM to assess performance and allocate resources. However, the SEC staff has clarified that the fact that information is included in a reporting package is not the only factor it considers in its assessment of identified operating segments.

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

Example SEC staff comment: Identification of operating segments

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

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

Identifying operating segments also affects goodwill impairment testing. If a registrant incorrectly identifies operating segments, this could cause a registrant to incorrectly identify reporting units used in goodwill impairment testing.

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 three criteria in ASC 280-10-50-11 are met. The criteria, which all require the use of judgment, are:

- ▶ The aggregation must be consistent with the objective and basic principles of ASC 280.

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

- ▶ 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.

To be consistent with the objective and basic principles of ASC 280, the aggregation of operating segments should help users of the financial statements make better-informed judgments about the registrant by improving their understanding of the registrant's performance and their assessment of the prospects for future net cash flows. That is, a registrant may aggregate operating segments only if reporting them separately will not add significantly to the investor's understanding of the entity because the segments' characteristics are so similar that they can be expected to have essentially the same future prospects.

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

ASC 280 requires that aggregated operating segments have "similar economic characteristics," such that they would be expected to have similar long-term financial performance. The similarity of the economic characteristics should be evaluated based on both current performance and future projections (ASC 280-10-55-7A). However, the SEC staff has said that the expectation that operating segments will have similar economic characteristics (e.g., long-term average gross margins) in the future does not take precedence over a lack of similarity in their current and past performance.

The SEC staff often reviews the registrant's website, analyst presentations and information in public filings and raises questions if any of that information is inconsistent with the registrant's conclusion that aggregating operating segments is appropriate. For example, a discussion of diverging trends or differing results at two business lines could indicate that these two business lines, if they qualify as operating segments, may not be economically similar.

The SEC staff has requested historical and projected operating margins, gross margins, revenues 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 for an explanation of why the registrant believes the five qualitative characteristics of the operating segments are similar, as required by ASC 280.

The SEC staff also has reminded registrants that the guidance on determining whether two operating segments are similar requires a company to consider the range of its business activities and the economic environment in which it operates.

For example, while a registrant with a diversified product portfolio may consider certain products similar, a registrant with a narrower range of activities may not consider those products similar.

In addition, the SEC staff has asked why a company's organizational structure caused it to identify separate operating segments and whether those reasons provide evidence that the operating segments are not similar.

Example SEC staff comment: Aggregation of operating segments

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

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

Ongoing assessment of reportable segments

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

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

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

The SEC staff may challenge whether a registrant has inappropriately included a non-GAAP measure in its segment disclosures.

Disclosures

General disclosures

ASC 280-10-50-21 requires registrants to disclose the factors they used to identify their reportable segments, including whether operating segments have been aggregated. If a registrant has not included this information in the segment footnote, the SEC staff has asked the registrant whether it has aggregated operating segments when determining reportable segments and has requested expanded disclosure in future filings. ASC 280-10-50-21 also requires disclosure of the types of products and services from which each reportable segment derives its revenues. The SEC staff has asked registrants to expand their disclosures when the information is not provided or does not include enough detail.

Reconciliations

ASC 280-10-50-30 requires registrants to provide reconciliations of the reportable segments' total revenues, measure of profit or loss, assets and other significant items, if disclosed, to the corresponding consolidated amounts. The SEC staff has asked registrants to revise their disclosures if they have not disclosed these reconciliations. The SEC staff also has asked registrants about amounts included in an "other" reconciling item, since ASC 280-10-50-31 requires significant reconciling items to be separately identified and described.

Non-GAAP measures

By definition, a segment measure of profit or loss that a company is required to disclose in accordance with ASC 280 (i.e., the measure of segment profit or loss used by the CODM for purposes of making decisions about allocating resources to the segment and assessing its performance) is not a non-GAAP measure and is not subject to the SEC's rules and regulations on the use of non-GAAP financial measures.

The SEC staff's C&DIs on the use of non-GAAP financial measures address this point. The C&DIs say "because [ASC 280] requires or expressly permits the footnotes to the company's consolidated financial statements to include specific additional financial information for each segment, that information also would be excluded from the definition of non-GAAP financial measures."

However, the SEC staff may challenge whether a registrant has inappropriately included a non-GAAP measure in its segment disclosures. For example, registrants should be aware that a consolidated measure of segment profit may create a non-GAAP financial measure.

Example SEC staff comment: Non-GAAP measures in the segment footnote

While we note that your CODM uses segment operating income (loss) and segment operating margin percentage to evaluate segment performance, the format and labeling of your presentation include non-GAAP measures that are not measures of segment performance, and you are not allowed to present them in your financial statements pursuant to Item 10(e)(1)(ii)(C) of Regulation S-K. The amounts you present in the consolidated column for operating income (loss) and operating margin percentage are not amounts presented on your statement of income or that can be directly calculated therefrom. While you may present the total of profit or loss of individual segments as part of the reconciliation required by ASC 280-10-50-30(b), such presentations must be correctly labeled, and the reconciliations should be to the consolidated amounts presented in your financial statements. Please revise the format and labeling of your presentation to eliminate the non-GAAP measures consolidated operating income (loss) and consolidated operating profit margin percentage. See also Question 104.04 of the Compliance & Disclosure Interpretations for Non-GAAP Financial Measures.

The SEC staff also has said that registrants should not attempt to circumvent the non-GAAP rules by disclosing multiple measures of a segment's profit or loss in their financial statements. Similarly, the SEC staff may challenge a registrant that discloses a measure of segment profit or loss when it discloses only one reportable segment.

For further discussion, please refer to the *Non-GAAP measures* section of this publication.

*Entity-wide disclosures*Disaggregated revenue by product and service

ASC 280 also requires a registrant to disclose the revenues it derived from transactions with external customers for each product or service, or each group of similar products or services, if this information is not already provided as part of the segment information required by the standard. Entities that have only one reportable segment and that provide a range of products and services also are required to disclose revenues for each product or service, or each group of similar products or services. For example, a registrant with one reportable segment that sells consumer products and provides services would be required to disclose the revenues from each significant product line or service, or groups of similar products or services, in its segment disclosure.

Example SEC staff comment: Disaggregated revenue by product

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

The SEC staff often has asked registrants that have not disclosed disaggregated revenue information to do so or explain why such disclosure was not necessary. The SEC staff has challenged the absence of such a disclosure when the registrant's publicly disclosed information indicates that its reportable segments contain a range of products or services. The SEC staff also has questioned the absence of such a disclosure when a registrant has asserted that providing the disclosure was impracticable but the information was provided elsewhere (e.g., MD&A, earnings calls).

In addition to comments on disaggregated revenue disclosures pursuant to ASC 280, the SEC staff may also comment on registrants' disaggregated revenue disclosures in accordance with the requirements in ASC 606. See the *Revenue recognition* section of this publication for further discussion.

Disaggregated revenue by geography

ASC 280 requires a registrant to disclose certain revenue information attributed to its country of domicile and foreign countries. A registrant also is required to disclose this revenue information for each foreign country (ASC 280-10-50-41(a)) if it is material. The SEC staff has asked registrants to disclose revenues attributed to specific countries they refer to in their other disclosures about foreign locations if the revenue information with respect to those countries is material.

Revenue contributed by significant customers

ASC 280-10-50-42 requires registrants to disclose the 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 requested that registrants disclose such information when other disclosures indicate that there may be a concentration of sales to a particular customer.

EY resources

Financial reporting developments, Segment reporting: Accounting Standards Codification 280

Financial instruments

Classification and disclosures of instruments of registrants' own equity

The SEC staff may ask registrants about the classification of equity instruments and disclosures of their terms.

Summary of issues noted

The SEC staff asked registrants how they account for certain issued equity instruments (e.g., redeemable preferred stock, warrants, convertible instruments) and asked for additional information on the terms of those instruments. The staff's inquiries focus on the registrant's basis for conclusions relating to the classification of those instruments in permanent vs. temporary equity as well as the adequacy of disclosures of those instruments.

Analysis of current issues

Instruments of registrants' own equity may be classified in permanent equity, temporary equity or liabilities. The accounting for these instruments can be complex, depending on the relevant contractual terms and applicable authoritative literature. The SEC staff has issued several comment letters related to the application of that guidance.

The SEC staff has asked registrants how redemption provisions affect the classification of preferred stock and noncontrolling interests as permanent or temporary equity. ASC 480-10-S99 requires temporary equity classification if redemption features are not solely within the control of the issuer. Accordingly, the analysis of redemption provisions must include consideration of the ownership structure to determine which parties (i.e., the issuer or holders of those instruments) can trigger the redemption features. For example, if a holder of an equity instrument controls the issuer's board of directors, any decisions made by the board to trigger redemption features may be viewed as in the control of the holder, not the issuer, resulting in temporary equity classification.

The SEC staff also has asked registrants about the adequacy of their disclosures about equity instruments and, in some cases, directed registrants to disclose additional information about the rights, privileges and preferences of warrants and preferred stock. In addition, the staff has asked registrants when certain features (e.g., conversion options, anti-dilution protection) may be triggered.

Example SEC staff comment: Redeemable noncontrolling interests

Tell us and disclose in more detail how you determined that Class A common stock and Class B preferred stock should be classified as redeemable non-controlling interest in temporary equity. In addition, include the redemption amount on the balance sheet, as outlined in the disclosure requirements in Rule 5-02(27) of Regulation S-X. As part of your response, please cite relevant authoritative accounting guidance that supports the basis for your conclusions and the measurement of the carrying value of the non-controlling interests.

EY resources

[Financial reporting developments, Issuer's accounting for debt and equity financings](#)

Disclosures related to the realizability of deferred tax assets

Summary of issues noted

The SEC staff continues to focus on valuation allowances and registrants' disclosures about their assessment of the realizability of deferred tax assets in both the financial statements and MD&A.

The SEC staff often comments if a registrant's disclosures related to its assessment of the realizability of deferred tax assets appear to be insufficient. In particular, the SEC staff may question the realizability of deferred tax assets when a valuation allowance is not recorded by registrants and they have recognized consecutive annual losses or a significant loss in the current year. The SEC staff may ask registrants to explain their reasons for significantly changing a valuation allowance if the reasons are not clear from the disclosure.

Analysis of current issues

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

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

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

- ▶ Assessment of all available positive and negative evidence used to determine the realizability of deferred tax assets, how the evidence was weighted and the extent to which the evidence was objectively verifiable
- ▶ Consideration of the sources of future taxable income, including how deferred tax liabilities are factored into the assessment, how much future taxable income the registrant would need to fully realize the deferred tax assets and the nature of any tax planning strategy that is factored into the analysis
- ▶ Determination of a deferred tax asset valuation allowance, particularly when negative evidence suggests it might be necessary or positive evidence suggests it is unnecessary
- ▶ Change in a previously recorded valuation allowance when the evidence that led to this decision is not readily apparent

Overall, the questions that the SEC staff typically raises stem from what it perceives to be inadequate or overly general (i.e., boilerplate) disclosures in the financial statements and MD&A regarding how a registrant evaluated the realizability of deferred tax assets.

As noted above, the SEC staff has asked registrants about the positive and negative evidence they considered when a valuation allowance was significantly changed if the reason for that change is not clear. When determining the weight to place on each piece of evidence, registrants should consider how objectively verifiable the evidence is. By its very nature, future taxable income (exclusive of the reversal of existing temporary differences and carryforwards) requires estimates and judgments about future events.

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

Example SEC staff comment: Realizability of deferred tax assets

We note that you have net deferred tax assets of \$100 million as of 31 December 2018 and that you have been in a three-year cumulative loss position since 31 December 2017. Please provide us with your comprehensive analysis of the specific positive and negative evidence management evaluated in arriving at the conclusion that a full valuation allowance is not needed as of 31 December 2018. Your analysis should include the weighting of the evidence that is commensurate with the extent to which it is objectively verified. For any tax-planning strategies that you are relying on in your analysis, please ensure that your discussion provides us with a detailed explanation of their nature and any uncertainties, risks and assumptions for those strategies.

Share-based payments

Presentation and disclosure

Summary of issues noted

The SEC staff comments when a registrant has omitted disclosures required by ASC 718 (e.g., general terms of an award, method used for measuring compensation cost from an award) and it is unclear to the staff why the disclosures were omitted.

Analysis of current issues

Required disclosures

ASC 718-10-50-1 requires a registrant with one or more share-based payment arrangements to disclose information that enables users of the financial statements to understand (1) the nature and terms of such arrangements that existed during the period and the potential effects of those arrangements on shareholders, (2) the effect of compensation cost arising from share-based payment arrangements on the income statement, (3) the method of estimating the fair value of the equity instruments granted (or offered to grant) during the period and (4) the cash flow effects resulting from share-based payment arrangements. Although ASC 718 appears to take a principles-based approach to disclosure requirements, the guidance in ASC 718-10-50-2 includes several pages of detailed disclosure requirements described as the “minimum information” needed to achieve these disclosure objectives.

The SEC staff often comments when a registrant omits a disclosure described in ASC 718-10-50-2. If a registrant has not provided a required disclosure, the SEC staff often asks the registrant to explain and generally will not object if the omitted information is immaterial.

Example SEC staff comment: Required disclosures

Please tell us your consideration of disclosing the weighted average grant-date fair value of nonvested stock options, restricted stock and performance units at the beginning and end of the year. Please refer to ASC 718-10-50-2c.2.

EY resources

[Financial reporting developments, Share-based payment \(before the adoption of ASU 2018-07, Improvements to Nonemployee Share-Based Payment Accounting\)](#)

[Financial reporting developments, Share-based payment \(after the adoption of ASU 2018-07, Improvements to Nonemployee Share-Based Payment Accounting\)](#)

Fair value measurements

Disclosures of valuation techniques and inputs

Summary of issues noted

Fair value measurement continues to be a frequent area of scrutiny for the SEC staff. In its comments on registrants' compliance with fair value measurement disclosure requirements, the SEC staff focuses on disclosures about valuation techniques and inputs, including significant unobservable inputs, used in fair value measurements.

Analysis of current issues

The SEC staff asks registrants to provide more robust disclosures about the valuation techniques and inputs they use in determining fair value, including valuation techniques and inputs used by third parties.

Example SEC staff comment: Valuation techniques

We note your disclosure that the Company's investments in residential mortgage-backed securities, interest rate swaptions and "to be announced" securities are valued using Level 2 valuations, and such valuations are determined by the Company based on independent pricing sources and/or third-party broker quotes, when available. In future filings, please revise your disclosure to describe the valuation techniques used by independent pricing sources and/or third-party pricing services to determine the fair value of these securities categorized within Level 2 of the fair value hierarchy. Refer to ASC 820-10-50-2(bbb).

The staff's questions continue to be granular, frequently focusing on specific inputs to a fair value measurement. For example, the staff may inquire about the basis for the valuation methodology applied and the basis for inputs used in the valuation, such as discount rates, selected valuation multiples and cash flow forecasts. Further, the staff may inquire about the weighting of multiple value indications when registrants use more than one valuation technique (e.g., internal model valuations and pricing indications from independent sources).

Example SEC staff comment: Specific inputs

You state that in performing a discounted-cash-flow-based valuation of the February 2018 convertible notes as of the date of financing, you determined that the cash proceeds from the convertible notes had an implied discount rate of 57.5%, from which you based the 55% discount rate you used in determining the valuation of your common stock. Please address the following:

- ▶ Tell us how you determined the convertible notes had a 57.5% discount rate and why the discount was attributed solely to the issuances of the notes.
- ▶ Tell us whether or not the notes were to an unrelated party.
- ▶ Confirm that there were no other contemporaneous agreements at or around the time of the agreement.
- ▶ Tell us why you believe use of the 55% discount rate is appropriate in determining the valuation of your common stock.

Example SEC staff comment: Multiple valuation techniques

We note that you performed goodwill impairment assessments using a combination of the income, cost and market valuation methodologies. If you utilized multiple valuation approaches in determining fair value for your reporting units, please tell us the relative weighting assigned to each method and how you determined the weighting was appropriate. Also, tell us whether the weighting changed or remained the same at each assessment date and your basis for any change.

The SEC staff also comments on disclosures about fair value measurements categorized in Level 3 of the fair value hierarchy. These comments generally focus on a registrant's failure to provide required disclosures about valuation techniques and inputs and quantitative information about the significant unobservable inputs used in the fair value measurement. For example, the staff may ask why a registrant does not disclose the sensitivity of the Level 3 measurement to changes in significant unobservable inputs or may request that the registrant provide the range of unobservable inputs used in Level 3 measurements.

Example SEC staff comment: Significant unobservable inputs disclosures

We note your disclosure that your Level 3 debt securities primarily consist of preferred stock investments in privately held companies without readily determinable market values. Your disclosure also states that unobservable inputs used in the models are significant to the fair values of the assets and typically reflect management's estimates of assumptions that market participants would use in pricing the asset. Please revise your disclosure to provide quantitative information about the significant unobservable inputs used in the fair value measurement as required by ASC 820-10-50-2(bbb). Furthermore, we note your disclosure that an increase or decrease in any of the unobservable inputs in isolation could result in a significant change in the fair value measurement. In accordance with ASC 820-10-50-2(g), revise this disclosure to provide a narrative description of the sensitivity or uncertainty of the fair value measurement, specifically describing each of the significant unobservable inputs and describing any of the interrelationships between those inputs and other unobservable inputs.

EY resources

[Financial reporting developments, Fair value measurement](#)

Contingencies

Accounting for and disclosure of loss contingencies

Summary of issues noted

Loss contingencies continue to be an area of frequent comment. In its comments on registrants' compliance with loss contingency disclosure requirements, the SEC staff focuses on disclosures about reasonably possible losses and the clarity and timeliness of loss contingency disclosures.

Analysis of current issues

The SEC staff questions a registrant's failure to make required note disclosures when there is a reasonable possibility of a loss of more than the amount accrued. The SEC staff verifies that a registrant has disclosed an estimate of the amount or range of reasonably possible losses or made a specific disclosure that the amount of loss cannot be estimated.

The SEC staff generally has not objected when registrants make either of the following disclosures, as applicable, about reasonably possible losses to comply with ASC 450:

- ▶ The amount or range of reasonably possible losses on an aggregate basis¹
- ▶ The amount or range of reasonably possible losses in certain cases and a statement that the registrant cannot estimate an amount for other cases

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

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

The SEC staff also has challenged the use of limited time periods to develop a loss estimate when expected payments are reasonably expected to continue beyond the timeframe used to develop the estimate. An example would be a contingency measured using expected payments over a five-year period if losses are expected to continue beyond that period.

¹ While it is acceptable to aggregate the amount or range of all reasonably possible losses, the SEC staff has objected to the aggregation of losses in all categories (i.e., it is not acceptable to disclose one estimate combining probable, reasonably possible and remote loss contingencies).

Example SEC staff comment: Disclosure about reasonably possible losses

You indicate that you believe the ultimate outcome of the various legal proceedings to which you are a party, individually and in the aggregate, will not materially harm your financial position, results of operations or cash flows. In accordance with ASC 450-20-50, if it is at least reasonably possible that a loss exceeding amounts already recognized may have been incurred and the amount of that additional loss would be material, either disclose the estimated additional loss, or range of loss, that is reasonably possible or state that such an estimate cannot be made.

The SEC staff requests that a registrant's disclosures use terms that are consistent with the language in ASC 450 when discussing the likelihood of occurrence (i.e., probable, reasonably possible or remote) and the estimated reasonably possible loss (i.e., additional loss, range of loss, an estimate cannot be made or the estimated additional loss or range of loss is not material).

The SEC staff expects disclosures about loss contingencies to evolve to include more quantitative information as the matter progresses. The SEC staff sometimes issues comments on the same matter in subsequent annual and quarterly periods.

Further, the SEC staff may challenge the adequacy of historical disclosures when loss contingencies have been settled. In particular, the SEC staff reviews prior period disclosures and inquires whether disclosures or accruals were sufficient in the prior periods based on the development of the matter.

Leases

Adoption of ASC 842

Summary of issues noted

While the SEC staff has not yet issued many comments on the application of ASC 842, the comments it has issued have generally focused on the completeness of a company's disclosures, including disclosures related to transition and discount rates. The low number of comments for the year ended 30 June 2019 is possibly a result of the limited number of early adopters of the new leases standard.

Certain other SEC staff comments have focused on presentation of lease-related cash flows on the statement of cash flows and accounting for specific arrangements, including registrants' involvement in asset construction (i.e., build-to-suit arrangements related to assets that the registrant will lease).

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

Oil and gas reserves

Summary of issues noted

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

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

The SEC staff has also requested additional information to support reserve amounts, including well information, income forecasts, engineering reports, maps and other documentation. The SEC staff inquires about how information that may be relevant to the recognition of oil and gas reserves is evaluated by management. This information may include current and expected market prices, development costs and other estimates that may be relevant to the recognition of oil and gas reserves.

Analysis of current issues

Recognition of proved undeveloped reserves (PUDs)

To recognize PUDs, a registrant must have made a final investment decision to develop an oil and gas property within five years of initial disclosure, with limited exceptions. To meet this criterion, the registrant must be able to demonstrate, with reasonable certainty, that it will execute the development plan within the five-year period. The SEC staff expects development plans to include management's expectations about capital expenditures and related financing. If the registrant changes its development plan, the SEC staff may question whether the registrant had previously reached a final investment decision.

The SEC staff may request historical information, such as rollforwards of PUD properties, to evaluate how closely the registrant's drilling activities on specific properties align with its plans for those properties. A registrant that cites a significant change in prices to explain a change in its development plan may receive questions from the SEC staff about whether it has identified the appropriate period to recognize PUDs. If planned drilling has not occurred, the staff may challenge whether the registrant appropriately recognized PUDs in the past and whether the registrant should continue to do so.

Example SEC staff comment: Final investment decision

Please provide us with your development schedule, indicating for each future period, the net quantities of proved reserves and estimated capital expenditures necessary to convert all of the proved undeveloped reserves disclosed as of 31 December 2018 to be developed. Please refer to Rule 4-10(a)(31)(ii) of Regulation S-X and Question 131.04 in the Compliance and Disclosure Interpretations, and either confirm or tell us the extent to which all of the proved undeveloped locations are part of a development plan that has been adopted by your management, including approval by your Board of Directors, if such approval is required, and is current as of 31 December 2018. Include details specifying the steps you have taken to demonstrate more than the mere intent to develop these PUDs.

Conversion of PUDs

The SEC staff requests that registrants with a large percentage of proved reserves classified as PUDs provide additional information about the amount and percentage of PUDs that were converted to developed reserves over the past several years. When the average historical conversion rates are less than 20%, the SEC staff may challenge whether the registrant will be able to execute plans to develop PUDs within the five-year guideline. The SEC staff also may request that registrants expand their disclosures about factors that affected historic conversion rates and their current expectations about the development plan for PUDs.

Example SEC staff comment: PUD conversion

You disclose that you converted approximately 10% of the PUD reserves available at year-end 2018 to developed status. In part, the Glossary of FASB ASC 932-235-20 limits "Proved Undeveloped Oil and Gas Reserves" as follows, "Undrilled locations can be classified as having undeveloped reserves only if a development plan has been adopted indicating that they are scheduled to be drilled within five years, unless the specific circumstances justify a longer time." Given that your rate of development, if sustained, would not be sufficient to develop your reserves over the next five years, disclose the reasons for the limited progress made during 2018 and explain how your plans relating to the conversion of your remaining proved undeveloped reserves have changed to ensure that your reserve estimates adhere to the criteria in Rule 4-10(a)(31)(ii) of Regulation S-X. Please note, disclosure under Item 1203(c) of Regulation S-K should inform readers regarding progress, or lack thereof, and any factors that affected progress in converting proved undeveloped reserves to developed status.

The SEC staff has asked registrants to expand disclosures about the cost to develop PUDs. Additionally, the SEC staff has inquired about the effects of expected reductions in capital spending on PUD development plans or challenged expected development cost assumptions in the standardized measure of discounted future net cash flows when these assumptions deviate significantly from historic results.

The SEC staff has asked registrants to expand disclosures about the cost of developing PUDs.

Example SEC staff comments: PUD conversion costs

We note that you disclosed that in preparing your 2019 capital expenditure budget of approximately \$50 million, you had assumed there would be an improvement in commodity prices by the summer of 2019, although you also indicate that if commodity prices stayed at current levels or declined further, your capital expenditure budget could be reduced to approximately \$20 million. You also disclose that substantially all of the \$20 million would be spent on completing previously drilled wells in the XYZ Field in the ABC region and that these wells were classified as proved developed non-producing as of 31 December 2018. Please tell us and expand your disclosure to explain how your development plan schedules comply with the timeframe stipulated in Rule 4-10(a)(31)(ii) of Regulation S-X, regarding the proved undeveloped reserves that you have disclosed as of 31 December 2018.

Explanation of changes in proved reserves

ASC 932-235-50-5 requires disclosures of changes in net quantities of an entity's proved reserves. Changes resulting from revisions of previous estimates, improved recovery, purchases of minerals in place, extensions and discoveries, and production and sales of minerals in place must be shown separately with appropriate explanation of significant changes. Item 1203(b) of Regulation S-K requires disclosures about material changes in PUD reserves.

The SEC staff frequently asks registrants to expand their disclosures relating to changes to both proved reserves as a whole and to PUD reserves to include all relevant factors that affected the changes, including offsetting amounts.

Example SEC staff comment: Explanation of changes in proved reserves

Expand your disclosure of changes in total proved reserves to provide an explanation of the significant changes related to each line item entry other than production. To the extent that two or more unrelated factors are combined to arrive at the line item figure, your disclosure should separately identify and quantify each individual factor that contributed to a significant change so that the change in net reserves between periods is fully explained. The disclosure relating to revisions in the previous estimates of your reserves should identify such factors as changes caused by commodity prices, well performance, uneconomic proved undeveloped locations or changes resulting from the removal of proved undeveloped locations due to changes in a previously adopted development plan. Refer to ASC 932-235-50-5.

Example SEC staff comment: Explanation of changes in PUDs

Please expand your disclosure to provide an explanation for the material changes in the net quantities of your proved undeveloped reserves that occurred during the year. Your disclosure should reconcile the overall change for the line item by separately identifying and quantifying each factor, including any offsetting factors, that contributed to a material change in your proved undeveloped reserves so that the change in net reserves between periods is fully explained. For example, for revisions in previous estimates, identify such factors as changes caused by commodity prices, well performance, uneconomic proved undeveloped locations or the removal of proved undeveloped locations due to changes in a previously adopted development plan. Refer to Item 1203(b) of Regulation S-K.

Expiring acreage

Item 1208(b) of Regulation S-K requires disclosures under appropriate captions in SEC filings about undeveloped acreage, both leases and concessions, including, if material, the minimum remaining terms of leases and concessions. When a registrant has a significant number of lease expirations in the near term, the SEC staff frequently asks whether there are significant PUD reserves associated with those properties and whether they will be developed before the lease expires.

Example SEC staff comment: PUDs and expiring acreage

If there are material quantities of net proved undeveloped reserves assigned to locations that are currently scheduled to be drilled after lease expiration, expand the disclosure under this section to describe the steps and related costs that would be necessary to extend the time to the expiration of such leases.

Appendix A: Industry 'Top 5 Tables'

The following tables summarize the topics the SEC staff focused on most often in comment letters to registrants classified by industry. Many of these topics are frequent areas of comment in letters received by registrants that are covered in the rest of this publication.

Aerospace and defense

Comment area	Comment rank for the 12 months ended 30 June*	
	2019	2018
Revenue recognition	1	3
ICFR, disclosure controls and procedures	2	**
Accounts receivable and cash reporting	3	**
Non-GAAP financial measures	4	1
Segment reporting	5	4

Automotive

Comment area	Comment rank for the 12 months ended 30 June*	
	2019	2018
MD&A	1	1
Income taxes	2	4
Non-GAAP financial measures	3	2
Segment reporting	4	5
Revenue recognition	5	**

Airlines

Comment area	Comment rank for the 12 months ended 30 June*	
	2019	2018
Revenue recognition	1	**
Leases	2	**
Cash flows statement classification	3	**
Non-GAAP financial measures	4	4
State sponsors of terrorism	5	**

Banking

Comment area	Comment rank for the 12 months ended 30 June*	
	2019	2018
Loan receivables – valuation and allowance	1	2
Non-GAAP financial measures	2	1
Revenue recognition	3	**

Health care

Comment area	Comment rank for the 12 months ended 30 June*	
	2019	2018
Non-GAAP financial measures	1	2
Loss reserves disclosures	2	**
MD&A	3	3
Revenue recognition	4	**
Consolidation	5	**

Insurance

Comment area	Comment rank for the 12 months ended 30 June*	
	2019	2018
Short-duration disclosures	1	1
Revenue recognition	2	4
Non-GAAP financial measures	3	2
ICFR, disclosure controls and procedures	4	5
Reinsurance	5	**

Life sciences

Comment area	Comment rank for the 12 months ended 30 June*	
	2019	2018
Revenue recognition	1	2
MD&A	2	1
Non-GAAP financial measures	3	**
Research and development expenses	4	3
Intangible assets and goodwill	5	**

Media and entertainment

Comment area	Comment rank for the 12 months ended 30 June*	
	2019	2018
Revenue recognition	1	**
MD&A	2	1
Non-GAAP financial measures	3	5
Intangible assets and goodwill	4	**
Fair value measurements***	5	4

Mining and metals

Comment area	Comment rank for the 12 months ended 30 June*	
	2019	2018
Mining reserves	1	2
MD&A	2	**
Signatures/exhibits/agreements	3	**
Inventory and cost of sales	4	**
Non-GAAP financial measures	5	1

Oil and gas

Comment area	Comment rank for the 12 months ended 30 June*	
	2019	2018
Oil and gas reserves	1	1
MD&A	2	2
Non-GAAP financial measures	3	3
Fair value measurements***	4	4
Segment reporting	5	**

Power and utilities

Comment area	Comment rank for the 12 months ended 30 June*	
	2019	2018
MD&A	1	**
Non-GAAP financial measures	2	1
Fair value measurements***	3	2
Intangible assets and goodwill	4	**
Asset retirement obligations	5	**

Real estate

Comment area	Comment rank for the 12 months ended 30 June*	
	2019	2018
Non-GAAP financial measures	1	1
MD&A	2	**
Fair value measurements***	3	2
Revenue recognition	4	**
Debt, warrants and equity securities	5	**

Retail and consumer products

Comment area	Comment rank for the 12 months ended 30 June*	
	2019	2018
Non-GAAP financial measures	1	2
MD&A	2	1
Intangible assets and goodwill	3	3
Revenue recognition	4	**
Fair value measurements***	5	4

Technology industry

Comment area	Comment rank for the 12 months ended 30 June*	
	2019	2018
Revenue recognition	1	4
Non-GAAP financial measures	2	3
ICFR, disclosure controls and procedures	3	**
MD&A	4	1
State sponsors of terrorism	5	2

Telecommunications

Comment area	Comment rank for the 12 months ended 30 June*	
	2019	2018
Revenue recognition	1	**
MD&A	2	2
Non-GAAP financial measures	3	1
Commitments and contingencies	4	**
Business combinations	5	**

* These rankings are based on topics assigned by research firm Audit Analytics for SEC comment letters issued to registrants about Forms 10-K from 1 July 2017 through 30 June 2019. In some cases, individual SEC staff comments are assigned to multiple topics if the same comment addresses multiple accounting or disclosure areas.

** This topic was not among the top five comment areas in 2018.

*** This category includes SEC staff comments on fair value measurements under ASC 820 as well as fair value estimates, such as those related to revenue recognition, stock compensation and goodwill impairment analyses.

Appendix B: SEC review process and best practices

The Division of Corporation Finance (DCF) of the SEC selectively reviews filings made under the Securities Act of 1933 and the Securities Exchange Act of 1934 (Exchange Act) to monitor and enhance compliance with disclosure and accounting requirements.

In their filing reviews, DCF accountants concentrate on disclosures and accounting methods that may conflict with US GAAP or SEC rules or that may need clarification. Other DCF staff members may review other aspects of SEC filings for compliance with the federal securities laws and regulations. DCF performs its primary review responsibilities through staff in 11 offices organized by industry². The DCF assigns public companies in a particular industry to one of these 11 Assistant Director Offices as shown below based upon their Standard Industrial Classification (SIC) code. Each company's office assignment is listed in EDGAR in the basic company information that precedes the company's filing history.

Office	Primary industries
1	Health care and insurance
2	Consumer products
3	Information technologies and services
4	Natural resources
5	Transportation and leisure
6	Manufacturing and construction
7	Financial services
8	Real estate and commodities
9	Beverages, apparel and mining
10	Electronics and machinery
11	Telecommunications

In its filing reviews, the DCF staff focuses on disclosures and accounting methods that may conflict with US GAAP or SEC rules or that need clarification.

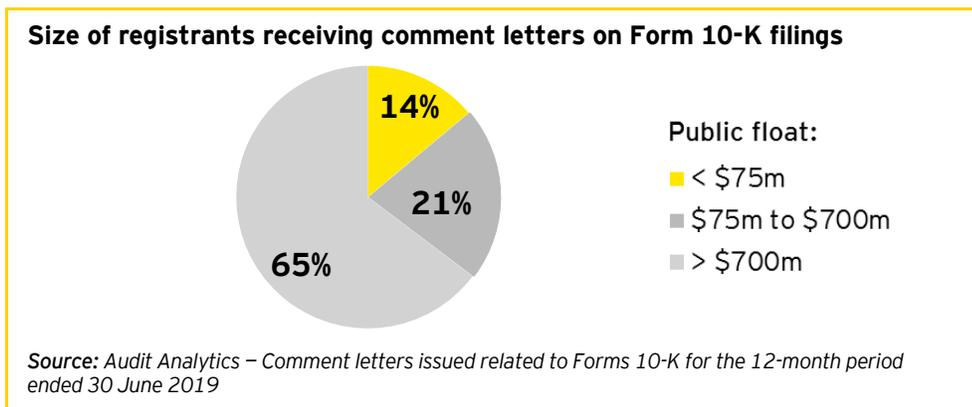
The SEC also has a number of legal and accounting technical offices staffed by people who support the filing reviews by focusing on highly technical matters without regard to specific industries. The staff in the assistant director offices consult most often with staff in the Offices of Chief Accountant, Chief Counsel, Mergers and Acquisitions, and International Corporate Finance. The DCF also has a Chief Risk Officer who focuses on developing risk-based approaches to regulatory policies and practices.

Required and selective review

As required by the Sarbanes-Oxley Act of 2002, the DCF staff reviews, at a minimum, every registrant's financial statements at least once every three years, but it reviews many registrants' financial statements more frequently. In addition, the DCF staff generally reviews all initial public offerings (IPOs) and selectively reviews other transactional filings, such as those made in connection with business combination transactions, proxy statements or other public offerings. The DCF staff sends "no review" letters when it has not selected an issuer's registration statement for review.

² The DCF makes changes to its industry group structure periodically. Its current structure is available at: <https://www.sec.gov/divisions/corpfina/cffilingreview.htm>

The SEC staff has reviewed slightly more than 50% of registrants each year since 2013. In addition, the SEC staff has sent the majority of its comment letters to larger public companies, as illustrated below³:



Levels of review

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

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

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

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

³ This graph shows the size (based on public float) of companies that received comment letters on Form 10-K filings during the 12 months ended 30 June 2019. However, the SEC staff may not send a comment letter to every registrant that it reviews.

DCF staff comments

The DCF staff views the comment process as a dialogue with a registrant about its disclosures. The DCF staff issues comments in response to a registrant's disclosures and other public information, based on its understanding of that registrant's facts and circumstances.

In its initial comments, the DCF staff often requests information so it can better understand the registrant's facts and circumstances. These requests should not be interpreted to mean that the staff has concluded that the disclosures must change. In many cases, comments are resolved once the DCF staff has gained a full understanding of a registrant's facts and circumstances and has obtained sufficient insight into the judgments made by management that led to the disclosures.

Registrants may commit to modifying their disclosure in the future in order to resolve certain comments. The DCF staff rarely requires a registrant to amend a filing unless the staff's comment relates to a transactional filing, such as an IPO or involves a material omission of a required disclosure or a material restatement of the financial statements.

Best practices for registrant responses to comments

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

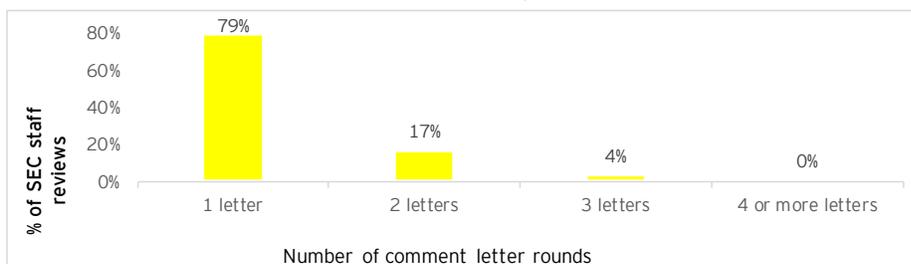
- ▶ Registrants should assume that the DCF staff has not yet concluded on a matter and merely needs more information, unless the staff clearly indicates in its comment this is not the case.
- ▶ Responses to each comment should focus on the question(s) asked by the SEC staff, and those responses should cite authoritative literature and related guidance wherever possible.
- ▶ Responses should address the registrant's unique facts and circumstances and provide insight into any judgments made. While it may be helpful to consider responses from other registrants on similar topics, registrants should not copy those responses.
- ▶ Registrants should file all response letters on EDGAR, redacting any specific information for which they are seeking confidential treatment.
- ▶ If revisions are being made to a filing as a result of a comment from the DCF staff, responses should indicate specifically where these revisions are being made. If disclosure will be modified in a future filing, it can be helpful for the registrant to provide proposed language in its response letter. Registrants should make it clear that facts and circumstances may change in a way that could require disclosure different than that proposed.
- ▶ Companies should seek the input of all appropriate internal personnel and professional advisors (such as legal counsel and independent auditors) so that the ultimate response to the comment letter is complete and accurate. Waiting for a later round of comments to involve the necessary resources may delay or hinder a successful resolution.

Providing a thorough explanation or analysis of an issue to DCF staff may help DCF staff better understand the accounting and disclosure, and it often will resolve the comment. To facilitate such responses, registrants should maintain contemporaneous documentation of significant accounting and disclosure decisions. Contemporaneous documentation is more persuasive than a retrospective defense following receipt of a DCF staff comment.

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

The following graph shows the number of comment letters (or rounds) that were issued by the SEC staff for reviews completed during the 12 months ended 30 June 2019:

Number of comment letters issued to complete review



Source: Audit Analytics – Comment letters related to Forms 10-K posted to EDGAR during the 12-month period ended 30 June 2019

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

A substantial majority of reviews are closed after one comment letter, and nearly all are resolved after two letters.

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

Closing a filing review

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

Reconsideration process

The DCF staff and the registrant may ultimately disagree about an accounting or disclosure matter. A registrant should, in any instance it wishes, seek reconsideration of a comment by other SEC staff, including those in the DCF's Office of the Chief Accountant (DCF-OCA).

DCF staff members, at all levels, are available to discuss disclosure and financial statement presentation matters with a registrant and its legal, accounting and other advisors. A registrant may request that more senior DCF staff reconsider a comment or reconsider a DCF staff member's view of the registrant's response at any point in the filing review process. DCF does not have a formal protocol for registrants to follow when seeking reconsideration; a request for reconsideration may be oral or written.

Registrants also may ask the SEC's Office of the Chief Accountant (OCA), which is distinct from the DCF-OCA, to reconsider an accounting conclusion of the DCF staff at any stage in the process. Generally, the SEC's OCA addresses questions about the application of accounting principles while DCF resolves matters concerning the age, form and content of financial statements required to be included in a filing. Even before a registrant requests reconsideration, DCF staff may have consulted internally about the issue with DCF-OCA and then with OCA.

A registrant should initiate a reconsideration with OCA by informing the DCF staff of its intention to request such reconsideration. In these circumstances, a registrant does not need to make a submission directly to OCA if all of the relevant information is contained in comment letter responses from the registrant to DCF, although a separate submission to OCA may serve to expedite the process.

Disclosure requirements

The SEC requires that all entities defined as an accelerated filer, a large accelerated filer or a well-known seasoned issuer disclose, in their annual reports on Form 10-K or Form 20-F, written comments the DCF staff has made in connection with a review of Exchange Act reports that:

- ▶ The registrant believes are material
- ▶ Were issued more than 180 days before the end of the fiscal year covered by the annual report
- ▶ Remain unresolved as of the date of the filing of the Form 10-K or Form 20-F

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

Requests for waivers, pre-clearance and interpretive guidance

In line with their recent efforts to promote capital formation, SEC officials have actively encouraged companies to use Rule 3-13 of Regulation S-X to request relief from burdensome financial statement requirements that result in the disclosure of information that exceeds what is material to investors. The DCF staff may use its authority under Rule 3-13 to modify or waive a company's financial reporting obligations under Regulation S-X, based on the facts and circumstances, as long as modifying or omitting the disclosure is consistent with investor protection.

Companies should consider discussing any matters they believe have merit with the staff before drafting a written request for relief under Rule 3-13. Conversations with the staff can be especially valuable when a company has a novel or complex fact pattern. In these situations, a company can learn which points will be most relevant to the staff's evaluation. To make it easier for companies to reach the right person, the SEC staff has updated its FRM⁴ to include the names of staff members and the topics on which they answer questions.

Registrants also may request informal interpretive guidance from the DCF staff on a named or no-named basis in a telephone call to DCF staff or in a request form for interpretive guidance and other assistance on the SEC's website. Requests made by telephone or an online request form⁵ are informal and may remain anonymous; therefore, responses to such requests cannot be relied upon as formal positions of the DCF staff.

In addition, companies may pre-clear conclusions on the application of US GAAP (or IFRS) with the SEC's OCA. The OCA staff encourages companies to consult on a pre-filing basis when they are uncertain about accounting issues. More information about the procedures for consulting with OCA is available on the SEC's website at <http://www.sec.gov/info/accountants/ocasubguidance.htm>.

EY resources

To the Point, Companies should consider seeking relief from SEC disclosure requirements under Rule 3-13

⁴ DCF Financial Reporting Manual at: <https://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.pdf>.

⁵ The online request form is available at: https://www.sec.gov/forms/corp_fin_interpretive.

Appendix C: Abbreviations

Abbreviation	FASB Accounting Standards Codification
ASC 250	FASB ASC Topic 250, <i>Accounting Changes and Error Corrections</i>
ASC 280	FASB ASC Topic 280, <i>Segment Reporting</i>
ASC 340-40	FASB ASC Topic 340-40, <i>Other Assets and Deferred Costs – Contracts with Customers</i>
ASC 350	FASB ASC Topic 350, <i>Intangibles – Goodwill and Other</i>
ASC 450	FASB ASC Topic 450, <i>Contingencies</i>
ASC 480	FASB ASC Topic 480, <i>Distinguishing Liabilities from Equity</i>
ASC 606	FASB ASC Topic 606, <i>Revenue from Contracts with Customers</i>
ASC 718	FASB ASC Topic 718, <i>Compensation – Stock Compensation</i>
ASC 740	FASB ASC Topic 740, <i>Income Taxes</i>
ASC 805	FASB ASC Topic 805, <i>Business Combinations</i>
ASC 810	FASB ASC Topic 810, <i>Consolidation</i>
ASC 820	FASB ASC Topic 820, <i>Fair Value Measurement</i>
ASC 842	FASB ASC Topic 842, <i>Leases</i>
ASC 932	FASB ASC Topic 932, <i>Extractive Activities – Oil and Gas</i>
ASC 932-235	FASB ASC Topic 932-235, <i>Extractive Activities – Oil and Gas – Notes to Financial Statements</i>
SAB Topic 1.M	SEC Staff Accounting Bulletin Topic 1.M, <i>Financial Statements, Materiality</i>
Topic No. 2	SEC Staff in CF Disclosure Guidance Topic No. 2, <i>Cybersecurity</i>

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SCORE no. 06976-191US

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