

# SEC Reporting Update

## Highlights of trends in 2020 SEC comment letters

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### What you need to know

- ▶ Non-GAAP financial measures rose to the top spot in our list of the most frequent topics in SEC staff comment letters for the year ended 30 June 2020. Management's discussion and analysis and revenue recognition were second and third, respectively.
- ▶ The volume of SEC staff comment letters continued to decline and was down by 15% from the previous year.
- ▶ While the last several months of our analysis included the unprecedented effects of the worldwide COVID-19 pandemic, very few of the comment letters on periodic reports addressed disclosures relating to the pandemic.
- ▶ The SEC staff was, however, proactive in providing disclosure guidance on COVID-19 and issued a number of comment letters addressing these matters on registration statements, which can be a leading indicator of matters the staff may address in comments when reviewing periodic reports.

### Overview

The areas most frequently addressed in Securities and Exchange Commission (SEC or Commission) staff comment letters for the year ended 30 June 2020 were non-GAAP financial measures, management's discussion and analysis (MD&A) and revenue recognition.

In our review of SEC staff comment letters on periodic reports, we also found that the volume of SEC staff comment letters continued to decline and was down 15% from the previous year. The last several months of our analysis coincided with the worldwide COVID-19 pandemic.

To date, we have seen very few SEC staff comments on disclosures in periodic reports that address the pandemic. We believe this may be due to the SEC staff's efforts to make its expectations for disclosure known through guidance issued throughout the pandemic. However, the SEC staff could, at any time, conduct targeted reviews of pandemic-related disclosures if it has concerns about the level of compliance with the guidance it has issued as events evolve.

We also note that the SEC staff has issued a number of comments addressing disclosures about the pandemic in registration statements by companies conducting securities offerings, including initial public offerings. Comments issued to these companies can sometimes be a leading indicator of where the staff plans to focus in its reviews in periodic reports. For that reason, we have included a discussion of those comments in the *COVID-19 observations* section of this publication. The pandemic-related comments to date have focused on the specificity of a company's disclosures of risk factors and the effects of the pandemic in MD&A.

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

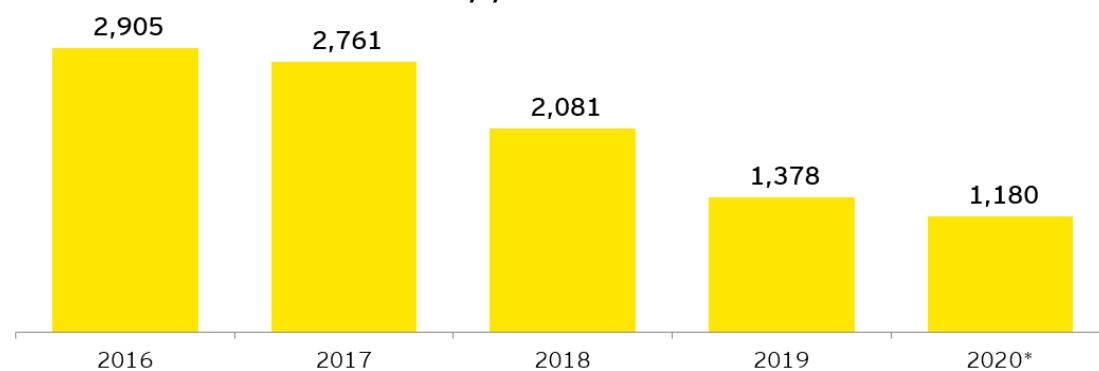
Companies receiving comment letters from the SEC staff should view the process as an opportunity to educate the staff about their facts and how they arrived at the conclusions leading to their disclosure rather than an indication that revisions are necessary. This should also include the company's consideration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

## Trends in 2020 SEC staff comment letters

### Number of SEC staff comment letters declined again

The volume of SEC staff comment letters in the year ended 30 June 2020 declined approximately 15% from the previous year, continuing the downward trend of recent years.

### Number of SEC comment letters by year



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

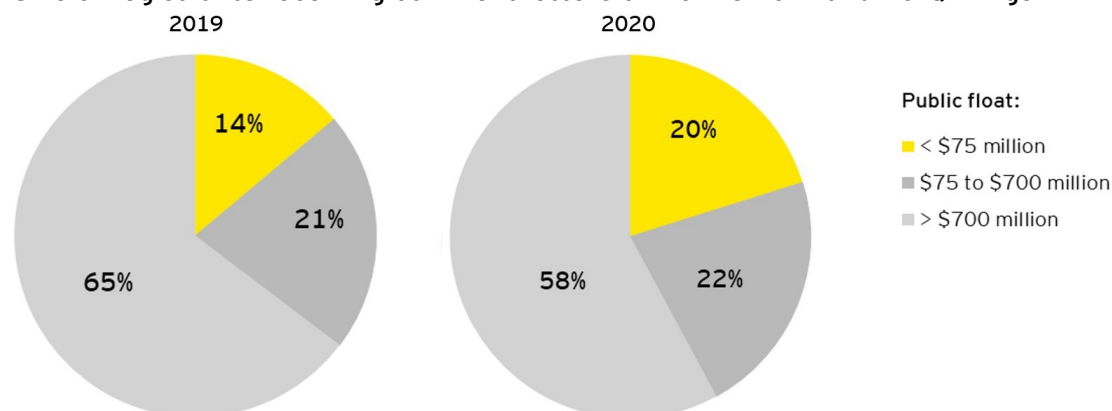
\* The SEC publicly releases comment letters no earlier than 20 business days after the completion of its reviews, meaning the SEC staff may have issued some letters before 30 June but those letters may not have been publicly available on that date.

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

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

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

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



Source: Audit Analytics - SEC UPLOAD comment letters issued related to Forms 10-K and 10-Q for the 12-month periods ended 30 June 2019 and 30 June 2020.

### Most frequent comment areas

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

Comment area	Ranking		Comments as a % of total registrants that received comment letters*
	12 months ended 30 June		
	2020	2019	2019 and 2020
Non-GAAP financial measures	1	2	37%
Management's discussion and analysis (MD&A)**	2	3	26%
Revenue recognition	3	1	33%
Segment reporting	4	8	11%
Fair value measurements***	5	4	9%
Intangible assets and goodwill	6	5	8%
Contingencies	7	****	5%
Inventory and cost of sales	8	****	5%
Income taxes	9	6	8%
Signatures/exhibits/agreements	10	9	5%

\* These rankings are based on topics assigned by research firm Audit Analytics for SEC comment letters issued to registrants with a market cap of \$75 million or more about Forms 10-K and 10-Q from 1 July 2018 through 30 June 2020. 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 (51%), (2) critical accounting policies and estimates (24%), (3) liquidity matters (20%), (4) business overview (18%), and (5) contractual obligations (7%).

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

\*\*\*\* This topic was not among the top 10 in 2019.

Non-GAAP measures and MD&A drew more scrutiny from the SEC staff than revenue recognition, which was the most frequent topic of comment letters last year because many registrants had recently adopted the new revenue standard and the SEC staff focused on their disclosures under that guidance. Disclosures under the new leases standard drew less scrutiny from the SEC staff, and there were only a few comments on the new credit losses standard, which large registrants have only recently adopted.

## COVID-19 observations

The SEC staff has issued only a handful of comments to date on disclosures relating to the pandemic in periodic reports. One reason may be that SEC Chairman Jay Clayton and other SEC officials issued a series of statements and the SEC's Division of Corporation Finance staff issued more detailed guidance beginning in March to help companies meet their disclosure obligations during these unprecedented times. These statements and guidance allowed companies to consider the SEC staff's expectations before providing their disclosure to investors.

The SEC staff has, however, issued a number of comments about disclosures relating to the pandemic to companies registering securities offerings, including initial public offerings, and comments on these filings can sometimes be a leading indicator of where the staff plans to focus its time on periodic reports.

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SEC officials have said they do not expect to second-guess good-faith efforts to provide appropriately framed forward-looking information.

### SEC statements and guidance

Chairman Clayton has emphasized that the way companies plan and respond to the events of the pandemic as they unfold can be material to an investment decision because of the scope and severity of the effects of the pandemic and intense investor interest. He has also said that companies should have robust controls and procedures in place to enable them to disclose material information related to COVID-19 in a timely manner.

Chairman Clayton and Division of Corporation Finance Director William Hinman issued a **statement** urging companies to provide as much information as practicable about their current operating and financial status and future plans in earnings releases and calls with analysts and investors. Although the statement was not focused on periodic reports, we believe it provides a useful framework for those reports. In their statement, Messrs. Clayton and Hinman urged companies to provide robust discussion about:

- ▶ Where the company stands today, operationally and financially
- ▶ How the company's COVID-19 response, including its efforts to protect the health and well-being of its workforce and customers, is progressing
- ▶ How its operations and financial condition may change as efforts to fight COVID-19 progress

Messrs. Clayton and Hinman said that companies should make the following disclosures about any governmental financial assistance that has affected or is reasonably likely to affect their financial condition or results in a material way: the nature of the assistance, the amount of the assistance and the effect of the assistance.

Messrs. Clayton and Hinman encouraged companies to make all reasonable efforts to convey meaningful information sufficient to allow investors to see the key operational and financial considerations and challenges companies face through the eyes of management. They also encouraged companies to take advantage of the safe-harbor liability protections provided by the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act) and said they do not expect the SEC to second-guess good-faith efforts to provide appropriately framed forward-looking information.

In addition, the SEC staff issued **Disclosure Guidance Topic No. 9**, which provided its views on disclosure and other securities law obligations that companies should consider with respect to COVID-19. The guidance provided questions on a wide range of topics that registrants can use to help develop disclosures about the effects of COVID-19.

The division supplemented this guidance with **Disclosure Guidance Topic No. 9A**, which focused on the effects of COVID-19 on companies' operations, liquidity and capital resources, and provided another round of questions on these matters that registrants can consider.

Finally, the SEC's Chief Accountant Sagar Teotia issued statements in **April** and **June** emphasizing the importance of high-quality financial reporting related to the COVID-19 pandemic.

Among other things, Mr. Teotia reminded companies to:

- ▶ Disclose significant judgments and estimates in a way that is understandable and useful to investors
- ▶ Consider how changes in financial reporting processes, including remote-work arrangements, affect control risk and how internal controls operate and can be tested
- ▶ Consider the need for new or enhanced internal controls in response to additional risks of material misstatement arising from changes to the business and other uncertainties

In both statements, Mr. Teotia said that the SEC staff will not object to well-reasoned judgments made more challenging by the uncertainties related to the pandemic. He also reiterated the responsibilities of registrants and auditors to evaluate a company's ability to continue as a going concern.

In his latest statement, Mr. Teotia also encouraged registrants to contact his office with any questions. He noted that his office has already addressed a number of financial reporting issues relating to COVID-19.

### **SEC comments on accounting and disclosures related to COVID-19**

The statements and guidance issued by the SEC made it clear that COVID-19 could affect all major sections of a company's periodic reports. So far, the SEC staff has mainly focused on disclosures made under Regulation S-K, including risk factors (Item 105) and MD&A (Item 303).

Some comments have been broad and appear intended to elicit disclosure throughout a company's filing. They reflect the overall philosophy of Messrs. Clayton and Hinman that a company should explain (1) where it stands today, (2) how management is responding to developments and (3) what the future might hold.

#### **Example SEC staff comment: General comment**

Please revise to discuss the effects, if any, that COVID-19 has had on your business, including what management expects its future impact will be, how management is responding to evolving events and how it is planning for COVID-19-related uncertainties going forward.

The SEC staff has asked some companies to provide more information about specific risk factors when the disclosures have been limited to general statements about uncertainties created by the pandemic. The SEC staff has asked for details that are tailored to a company's facts and circumstances.

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SEC officials have said detailed discussions of current liquidity positions and the availability of financial resources would be particularly helpful to investors and the markets.

#### Example SEC staff comment: Risk factors

We note your disclosure that the extent to which your operations may be impacted by the COVID-19 pandemic will depend largely on future developments, which are highly uncertain and cannot be accurately predicted, including new information that may emerge concerning the severity of the outbreak and actions by government authorities to contain the outbreak or treat its impact. Please amend your risk-factor disclosure to provide more detailed risks related to the COVID-19 pandemic, tailored to your specific facts and circumstances. For guidance, see CF Disclosure Guidance: Topic No. 9 (25 March 2020).

#### How we see it

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

The effects of the pandemic on many companies' 2020 results have been significant, particularly in the second quarter. Those companies typically added MD&A disclosure to explain those effects. However, the SEC staff has issued comments to companies even when disclosure specific to the pandemic has been included in MD&A. These comments have focused on making sure that companies are explaining their results in a way that is clear and understandable to investors.

#### Example SEC staff comment: MD&A disclosure – historical results

We note your disclosure that your overall revenues since 1 January 2020, were below expectations by approximately X% primarily due to COVID-19, and your revenues from providing services were below expectations by approximately Y%. Because investors do not know your expected revenue for this period, please revise to present the impact based on your historical financial performance. In this regard, please discuss how COVID-19 has impacted operations as compared to prior financial periods. Please refer to CF Disclosure Guidance: Topic No. 9 (25 March 2020).

Messrs. Clayton and Hinman said in their statement that detailed discussions of current liquidity positions and the availability of financial resources would be particularly helpful to investors and the markets during the pandemic. The SEC staff has asked companies to provide more information about debt covenants when it has reason to believe that violations are possible. Violations of debt covenants can have severe consequences (e.g., the debt must be repaid immediately), and companies typically need to negotiate with their lenders to cure the violations.

#### Example SEC staff comment: MD&A disclosure – liquidity position

We note that, given the uncertainty of the impacts of COVID-19, you are monitoring your ability to comply with debt covenants in future periods and are in discussions with certain counterparties to your debt obligations. In future filings, please expand your disclosures to include the significant debt covenants and the particular subsidiaries affected.

Forward-looking information about the pandemic has also been a focus of the MD&A comments issued by the SEC staff. That's because, given all of the economic uncertainty due to the pandemic, it's harder for investors to use historical results to develop expectations for a company's future performance.

**Example SEC staff comment: MD&A disclosure – forward-looking information**

We note in your filing you have a declining number of users year over year. Additionally, you derive a significant portion of your revenues from a small number of high-paying users. Please discuss your vulnerability to a near-term severe impact arising from the disruption of the economy by the COVID-19 pandemic that could affect the discretionary spending behavior of such users and thus, your revenues. In addition, disclose other material known or reasonably likely effects of and the types of risks presented by COVID-19 on your financial position and results of operations. Refer to CF Disclosure Guidance: Topic No. 9 (25 March 2020).

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

**Example SEC staff comment: MD&A disclosure – impairment of long-lived assets**

We note your disclosure that, due to general market declines driven by the coronavirus global pandemic, you performed impairment testing on your goodwill and indefinite-lived intangible assets. In both cases, you determined that the fair values of these assets exceeded their carrying value. In order to provide investors with information to better assess the probability of future goodwill impairment charges, please disclose, if accurate, that the estimated fair values of the intangible assets you quantitatively tested for impairment substantially exceeded their carrying values. For any asset whose estimated fair value did not substantially exceed its carrying value, please disclose the percentage by which fair value exceeded carrying value at the date of the most recent test.

The SEC staff has also asked companies about matters related to the pandemic beyond the adverse effects on their business. For example, companies that are based in countries where the pandemic hit earlier than in the US have received comments that ask for more information about demand for their products and services when they reopened. These comments demonstrate a concern by the SEC staff that companies could lose focus on providing robust disclosure about the pandemic as operations improve.

**Example SEC staff comment: MD&A disclosure – recovery**

Please address more specifically how COVID-19 has impacted your services, explaining the extent to which you have reopened your business and demand has returned for your business following your office closure that ended on 10 February 2020. Refer to CF Disclosure Guidance: Topic No. 9 for further guidance.

The SEC staff has also sought to make sure that companies that are pursuing solutions to problems caused by the pandemic (e.g., biotech companies involved in vaccine development) are providing balanced disclosure.

**Example SEC staff comment: MD&A disclosure – new opportunity**

We note your disclosure that your partner company has successfully completed its COVID-19 vaccine prototype. Please update your disclosure to clarify the current clinical or pre-clinical stage of development of the vaccine product candidate and the jurisdiction. Make clear the possibility that the FDA may not accept clinical trials performed in other jurisdictions and may require additional testing. Please also balance your disclosure by stating that you will need to submit an Investigational New Drug application to the FDA and complete all phases of clinical trials before you can apply to receive marketing approval for this product candidate.

## Non-GAAP financial measures that adjust for COVID-19

To date, we have observed very few SEC staff comments on non-GAAP measures adjusted for effects of the COVID-19 pandemic, and those comments were mainly to request more information about the nature of the non-GAAP adjustments and method used to quantify them. We also have seen a few comments objecting to adjustments made to exclude the effects of COVID-19 on the provision for expected credit losses. The SEC staff has stated in the past that it is inappropriate to remove the full or partial effects of the new credit losses standard resulting from COVID-19 because doing so would be tailoring an accounting principle.

### Example SEC staff comment: Excluding a portion of the provision for credit losses

We note your disclosure of adjusted diluted earnings per common share excluding credit reserve builds, which excludes the portion of the provision for credit losses attributable to reserve builds [due to COVID-19]. It appears this performance measure, which excludes a portion of the provision for credit losses, substitutes individually tailored recognition and measurement methods for those of GAAP and violates Rule 100(b) of Regulation G, as discussed in Question 100.04 of the Non-GAAP Financial Measures C&DI. Please refrain from disclosing this performance measure, or any other performance measures, that excludes a portion of the provision for credit losses (e.g., the portion of the provision for credit losses that exceeds net write-offs) in future filings.

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

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

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

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

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

### Internal control over financial reporting (ICFR)

Most companies have concluded that they did not have material changes in ICFR related to COVID-19, but some of these companies have elected to expand their disclosures required by Item 308 of Regulation S-K. For example, some companies have expanded their quarterly disclosures to address their remote work environment and business continuity plans that were in place to mitigate the effect to the internal control environment. A few companies have



disclosed material changes in ICFR that resulted from the effects of COVID-19, such as changes made to the control environment due to the inability to perform interim physical inventory counts. The SEC staff may ask companies to explain how operational changes caused by the pandemic affected ICFR if the disclosures are silent on the effect of the pandemic.

### **CARES Act**

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

The SEC staff has provided guidance for companies that have received government assistance through the CARES Act and for companies facing substantial doubt about their ability to continue as a going concern. We expect to see comments in the second half of 2020 and beyond as the effects of the CARES Act are reflected in registrants' future periodic filings.

## **Other developments in the filing review program**

### **Approach to new regulations**

Shortly after the SEC amended Items 601(b)(2) and 601(b)(10) of Regulation S-K and permitted registrants to redact confidential information from material contracts filed as exhibits without requesting permission from the SEC staff to do so, the SEC staff issued a number of comment letters questioning the appropriateness of registrants' redactions.

Because these comment letters were not signed by individual staff members, we believe they represent a centralized effort by the SEC staff to evaluate compliance with the new rules, which the SEC adopted in 2019. As the SEC continues its rulemaking efforts, the SEC staff may use this approach again when the industry expertise of the review offices is not necessary to evaluate compliance with new rules.

### **Division of Corporation Finance reorganizes disclosure program**

The Division of Corporation Finance reorganized its disclosure review program and created the following seven industry-focused review offices to review filings rather than having staff in 11 assistant director offices perform the reviews:

- ▶ Energy & Transportation
- ▶ Finance
- ▶ Life Sciences
- ▶ Manufacturing
- ▶ Real Estate & Construction
- ▶ Technology
- ▶ Trade & Services

## How we see it

The SEC said the realignment would promote collaboration, transparency and efficiency within the Division of Corporation Finance. So far, we have not observed an increase in comment letters due to the realignment, but registrants may receive new comments on disclosures that have not changed significantly in recent years if new reviewers are assigned as a result of the realignment.

Also, a recent report<sup>1</sup> from the US Government Accountability Office noted that the SEC staff reallocated responsibilities for reviewing nonfinancial information (e.g., risk factors) in annual reports from attorneys to accountants. Reviews of annual reports have involved attorneys for nearly a decade. During that time, the review of an annual report would often involve an attorney reviewing the nonfinancial disclosure and an accountant to review financial disclosures. Some areas, like MD&A, were shared.

## Responding to a comment letter

### General

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

### Drafting the response letter

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

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

## Documentation

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

## Materiality

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

## Reconsideration

The SEC staff and the registrant may ultimately disagree about an accounting or disclosure matter. A registrant may seek reconsideration of a comment by other SEC staff, including those in the Division of Corporation Finance's Office of the Chief Accountant (CF-OCA). SEC staff members, at all levels, are available to discuss disclosure and financial statement presentation matters with a registrant and its legal, accounting and other advisers.

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

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

## Timing

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

## Non-GAAP measures

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

In addition, the SEC staff has continued to challenge whether a registrant was presenting a non-GAAP measure that employs an individually tailored accounting principle that may be misleading.

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

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

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

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

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

#### **Example SEC staff comment: Definition of a non-GAAP measure**

We noted your presentations of net income and operating cash flow from ongoing operations exclude the results of your X segment. As these measures appear to meet the definition of non-GAAP financial measures, revise to provide the disclosures required by Item 10(e) of Regulation S-K and Regulation G, as applicable.

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

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

The SEC staff 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. Refer also to Question 102.10 of the Non-GAAP Financial Measures C&DIs.

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

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

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

We 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 paragraphs (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.

**Compliance with C&DIs*****Individually tailored accounting principles***

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

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

The SEC staff has also reminded companies that, while the SEC staff did not object to measures presented to show the effect of adopting Accounting Standards Codification (ASC) 606, *Revenue from Contracts with Customers*, for the purpose of facilitating a comparison to prior periods during the transition year, measures that continue to reflect legacy accounting

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

after transition disclosures are no longer required are viewed by the staff to be inappropriate. The SEC staff has also said that it is not appropriate for companies that adopt ASC 326, *Financial Instruments – Credit Losses*, to present a non-GAAP measure that excludes the effect of the new standard, including any measures that exclude all or part of a company's provision for credit losses. See also the discussion of non-GAAP measures in the *COVID-19 observations* section.

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

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

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

#### **Example SEC staff comment: Adding back deferred revenue**

We note your computation of the non-GAAP measure Adjusted EBITDA included deferred revenue. Please tell us why revenue that is required to be deferred under GAAP is added back to your non-GAAP performance measure. Please also tell us the basis for the computation of the amounts added back in each year. Additionally, tell us how you considered whether this is an individually tailored revenue recognition and measurement method pursuant to Question 100.04 of the Non-GAAP Financial Measures C&DI.

### **How we see it**

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

#### ***Exclusion of normal, recurring cash operating expenses***

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

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

We note 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 C&DI on Non-GAAP Financial Measures.

## Management's discussion and analysis

### Results of operations

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

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

Item 303(a)(3) of Regulation S-K provides general instructions for preparing MD&A disclosures about the results of operations. See the *COVID-19 observations* section for a discussion of SEC staff statements and guidance related to disclosures that companies should consider with respect to business and market disruptions related to COVID-19.

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, including events that have been disclosed in the press but not disclosed in an SEC filing
- ▶ Provide insight into significant components of revenue or expense necessary to understand the results of operations (such as components of cost of sales)
- ▶ Describe any known trends or uncertainties that have had or are reasonably likely to have a material effect on sales, revenue or income from continuing operations (such as uncertainties arising from tariffs imposed on imports from foreign countries)
- ▶ Discuss how much of any material increase or decrease in revenue is due to business combinations or dispositions or changes in volume, product mix or pricing
- ▶ Discuss reportable segment information needed to understand their results of operations or discuss results at a more disaggregated level (e.g., product line)

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**

Please expand your results of operations discussion in future filings to quantify the impact of each factor identified, including offsetting factors, as causing changes in results between periods. For example, we note that your changes in revenue are attributable to a number of factors, including increases in unit volume, net impacts of price increases and changes in product mix. Please quantify the impact of each factor attributing to the increase, here, and throughout your discussion, in accordance with Item 303(a)(3)(iii) of Regulation S-K and Section III.D of SEC Release No. 33-6835.

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Item 303(a)(3) of Regulation S-K provides general instructions for preparing MD&A disclosures about the results of operations.

The SEC staff has also requested that companies provide forward-looking information about known trends and uncertainties, including forward-looking disclosures relating to the pandemic. See the *COVID-19 observations* section for an example of an SEC staff comment on a registrant's disclosure in MD&A of known trends and uncertainties relating to the pandemic.

Disclosure is required for trends and uncertainties that are reasonably likely to have a material effect on revenues or income from continuing operations. In evaluating this requirement, the registrant must determine whether the trend or uncertainty is reasonably likely to occur. If it isn't, no disclosure is required. If the registrant cannot make that determination, it must assume that the trend or uncertainty will occur, and it must disclose that item in MD&A, unless it is not reasonably likely to have a material effect.

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

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

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

To assess the completeness of MD&A disclosures in a registrant's periodic reports (e.g., Form 10-K, Form 10-Q), particularly those 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). The SEC staff has often asked registrants to expand their MD&A disclosures when information is not discussed in MD&A, but the entity had addressed it elsewhere.

**Example SEC staff comment: Results of operations – expanding MD&A based on information discussed in earnings release**

Please tell us why you appear to be able to distinguish between store and digital sales in your earnings calls and why you separately discuss digital sales in your earnings calls. Please reconcile this discussion during your earnings calls with the disclosures in your Form 10-K that you do not have a clear distinction between store and digital sales. Also tell us why your analysis of results of operations does not quantify net sales from your digital channel and does not disclose information about the increase in digital sales and the drivers of that increase similar to the information currently provided during your earnings calls.

***Significant components of expense***

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



**Example SEC staff comment: Results of operations – significant components of expense**

In regard to the gross profit of your health care distribution segment, you disclose the decline in gross profit was due to the decrease in the gross margin rates. Please provide an analysis of the specific factors that impacted the gross margin rates. Refer to Section III.B.4 of SEC Release No. 33-8350 for guidance. To the extent appropriate and material, include the impact on the rates of underlying factors associated with cost of sales.

***Key financial and operating metrics***

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

The SEC issued *Commission Guidance on Management's Discussion and Analysis of Financial Condition and Results of Operations* (Release No. 33-10751), effective 25 February 2020, advising registrants to provide additional disclosures about KPIs and other metrics included in MD&A. The disclosures required by the guidance are generally consistent with those the SEC staff has encouraged over the years in public statements and comment letters. However, the issuance of Commission-level guidance could lead to additional staff focus on disclosures about metrics companies include in MD&A. See our To the Point, [\*\*SEC issues guidance on disclosures about key performance indicators and other metrics in MD&A\*\*](#), for further discussions of the guidance.

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

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

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

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

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

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

The SEC staff may also ask a registrant to disclose KPIs 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: KPIs

We note that during your quarterly earnings calls you refer to certain key performance indicators. To the extent that the measures are key performance indicators used in managing your business, please consider revising to include a discussion of the measures in your MD&A section, along with comparative period amounts, or explain why you do not believe this disclosure is necessary. Refer to Section III.B.1 of SEC Release No. 33-8350 and SEC Release 33-10751.

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

#### Critical accounting estimates

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

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

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

SEC officials also have stressed that, during the pandemic, companies need to disclose significant judgments and estimates in a manner that is understandable and useful to investors, given all of the uncertainty. See the *COVID-19 observations* section for additional discussion of SEC staff statements and guidance emphasizing the importance of high-quality financial reporting related to the COVID-19 pandemic.

The SEC staff has noted that registrants' disclosures about critical accounting estimates often are too general and should provide a more robust analysis than what is in the significant accounting policies note to the financial statements. While accounting policies in the notes to the financial statements generally describe the method used to apply an accounting principle, the discussion in MD&A should provide more insight into the uncertainties involved in applying the principle at a given time and the variability that is reasonably likely to result from its application.

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

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

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 would 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.

**Example SEC staff comment: Quantitative sensitivity analysis**

Please tell us why you removed your disclosure about the range of actuarial estimates related to your latest loss reserve estimate. In your response, tell us how your current disclosure provides readers with information to assess the variability and sensitivity of your loss reserve estimate to reasonably likely changes in the key underlying reserving assumptions consistent with the guidance in Section V of Release No. 33-8350.

The SEC staff may ask a registrant how its discussion of specific critical accounting estimates aligns with information appearing in the notes to the financial statements, in a press release, or elsewhere.

**Example SEC staff comment: Enhanced disclosure**

We note that you have not recorded a valuation allowance against your significant US jurisdiction deferred tax assets. In light of the objective and verifiable negative evidence in the form of cumulative losses over the three years ended 31 December 2019, please tell us your consideration of providing more robust critical accounting policy disclosures regarding the various judgments and assumptions made in determining the deferred tax assets are realizable, including a discussion of the degree of uncertainty associated with key assumptions. Such discussion would desirably provide specifics (e.g., projected future taxable income assumes revenue and margin growth rates of X% and positive net income by what year) as well as a description of potential events and/or changes in circumstances that could reasonably be expected to negatively affect the key assumptions. Please refer to Item 303(a)(3)(ii) of Regulation S-K and SEC Release No. 34-48960.

### Liquidity and capital resources

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

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

Further, the SEC staff may request more comprehensive disclosures about alternative sources of funding and material debt covenants when there is an elevated risk of default or when management has concluded it is reasonably likely that covenants will be violated in the future.

#### **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. See the *COVID-19 observations* section for a discussion of SEC staff statements and guidance, including Disclosure Guidance Topic No. 9A, which says that it is important for companies to provide robust and transparent disclosures about how they are dealing with short- and long-term liquidity risks during the pandemic, particularly if those efforts create new risks or uncertainties for their businesses.

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

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

#### **Example SEC staff comment: Changes in operating cash flows**

It appears from the statement of cash flows that changes in assets and liabilities, which includes working capital items, is the substantial cause of the increase in 2019 operating cash flows compared to 2018. Please revise your disclosure to discuss the material items and the associated underlying factors contributing to the variance. Refer to IV.B.1 of SEC Release No. 33-8350 for guidance. Quantify any factors cited, pursuant to section 501.04 of the staff's Codification of Financial Reporting. Additionally, define what you consider to be your working capital.

The SEC staff also has requested that registrants disclose:

- ▶ Whether identified trends will continue, and if so, how long they will continue and steps the registrant is taking to address the trends, including plans to remedy any identified material uncertainties or unfavorable trends in short- or long-term liquidity
- ▶ An analysis of all internal and external sources of liquidity, beyond cash on hand, as of the balance sheet date
- ▶ Amounts outstanding and available at the balance sheet date under each source of liquidity, with a comparison to cash needs over the next 12 months, including any significant planned capital expenditures
- ▶ The sufficiency of the amounts available under existing credit arrangements, the anticipated circumstances requiring their use, any uncertainty about the registrant's ability to access these funds when needed and the implications of not being able to access the arrangements

#### **Example SEC staff comment: Liquidity deficiencies**

We note that you raised \$[X] million and \$[X] million in financing transactions in 2018 and nine months ended 30 September 2019. You also had significant negative cash flows from operations for both the fiscal year ended 31 December 2018, and nine months ended 30 September 2019. As such, please expand your Liquidity and Capital Resources section to identify any material liquidity deficiencies. Address any known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in liquidity increasing or decreasing in any material way. Your discussion should analyze your ability to meet your liquidity needs both on a long-term and short-term basis.

When there is a heightened risk of debt default (e.g., adverse trends in cash flows or operating results, recent covenant waiver requests, significant amount of debt maturing within 12 months), the SEC staff requests enhanced disclosure about alternative sources of funding, debt covenants, and the potential risks and effects of noncompliance on the registrant's financial condition and liquidity. Specifically, the SEC staff may request the following types of disclosure:

- ▶ Alternative sources of funding to refinance existing debt obligations
- ▶ Specific terms of material debt covenants and whether the registrant is in compliance with the covenants
- ▶ Quantitative information, such as ratios or amounts compared with minimum/maximum ratios or amounts required by debt covenants, along with explanations of how these ratios or amounts are determined and their relationship to amounts reported under US GAAP
- ▶ The nature of waivers or modifications of existing debt covenants obtained to cure or prevent potential violation(s), including how long any waivers apply, and a description of the covenant
- ▶ The likelihood of violating financial covenants in the future

#### ***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 provide disclosure that is clear and understandable and that appropriately reflects the categories of obligations that are meaningful in light of their capital structure and business. Registrants 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 their reasons for excluding certain items from the table. Most notably, the SEC staff has asked companies to include future interest payments, including variable interest, in the contractual obligations table or a footnote to the table. When interest rates are variable, registrants should describe the assumptions that were used to estimate future payments.

#### **Example SEC staff comment: Contractual obligations table**

It appears the cash interest payments on your credit facility and debt obligations may represent a material contractual obligation. Because this table is aimed at increasing transparency of cash flow, we believe these payments should be included in the table or disclosed in the footnotes using the same time frames stipulated in the table. Please also disclose any assumptions you made to derive these amounts. If you choose not to include these payments, a footnote to the table should clearly identify the excluded items and provide any additional information that is material to an understanding of your cash requirements. Refer to Item 303(a)(5) of Regulation S-K and footnote 46 to SEC Release No. 33-8350.

In January 2020, the SEC proposed eliminating the requirement for companies to include selected financial data, selected quarterly financial data and contractual obligations tables in filings. The proposal also would change or clarify certain rules in MD&A and codify requirements for disclosures about critical accounting estimates that currently appear only in interpretive guidance. Once finalized, the amended rules could materially affect registrants' MD&A disclosures and likely will drive staff comments. See our To the Point, [\*\*SEC proposes eliminating certain Regulation S-K requirements and enhancing MD&A disclosures\*\*](#), for further details on the proposal.

## Internal control over financial reporting and disclosure controls and procedures

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

- ▶ The implications for ICFR and DCPs when a registrant discloses an error correction, regardless of whether it is material
- ▶ The effectiveness of DCPs when management concludes that ICFR is ineffective
- ▶ Disclosure of cybersecurity incidents and their implications on the assessment of DCPs
- ▶ The nature of material weaknesses and the timeliness of their identification
- ▶ The omission of disclosures about changes in ICFR after significant events that make material changes likely, such as a business combination or a significant accounting change
- ▶ The omission of the ICFR language from the Section 302 certification of the Sarbanes-Oxley Act

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

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

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

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

**Example SEC staff comment: Immaterial error correction and ICFR**

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 DCPs, as well as ICFR, 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 and 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 DCPs and ICFR are either "effective" or "ineffective." Generally, the SEC staff challenges registrants that inappropriately express management's conclusions, saying that disclosure controls and procedures are "adequate," "effective, except for" or "effective except as disclosed below."

**Example SEC staff comment: Inappropriate management assessments**

Your statement that your "remediation plan to measure the effectiveness of the revised disclosure controls and procedures has not been in place long enough to fully assess their control design and effectiveness" does not comply with Item 307 of Regulation S-K, as it does not provide a definitive conclusion as to the effectiveness of your DCPs. Accordingly, please amend the filing to disclose the conclusion of your principal executive and principal financial officers regarding the effectiveness of the company's DCPs as of the end of the period covered by the report. To the extent that you conclude that your DCPs are not effective due to the limited amount of time for which your remediation plan has been in place, please ensure that the status of your remediation plans is adequately disclosed.

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

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

**Example SEC staff comment: DCPs and ICFR**

Please explain to us how you determined that your DCPs were effective, particularly considering you have identified an unremediated material weakness related to lack of sufficient resources with appropriate experience to interpret complex accounting guidance and prepare financial statements and disclosures in accordance with GAAP. In this regard, DCPs often include those components of ICFR that provide reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in accordance with GAAP. Please tell us how you determined that the material weakness you identified would not be considered a component of ICFR that is also included in DCPs.

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

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

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

**Example SEC staff comment: Cybersecurity incident effect on DCPs**

We note your reference within the Form 10-K and in a Form 8-K that the Company had a data breach that affected XX million users. You indicated, to date, unauthorized users have not had a material effect on your Company. Please tell us how you reached such a conclusion.

Additionally, tell us how you considered disclosure of the following, hereunder, elsewhere in this filing and in your Form 10-Q:

- ▶ The details of such an incident, including your assessment of its magnitude and financial, legal or reputational consequences
- ▶ Why there was a delay between the date of the incident and the date it was reported
- ▶ How you considered the cybersecurity incident in your assessment of DCPs
- ▶ Any action you have taken to remediate the incident and mitigate the harm

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

### Section 302 certifications

The management certification required under Section 302 of the Sarbanes-Oxley Act must be filed as Exhibit 31 to Form 10-K. The form of this certification must be filed exactly as specified in Item 601(b)(31)(i) or (ii) of Regulation S-K. Separate certifications must be filed by the principal executive officer and the principal financial officer.

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

When preparing officer certifications, registrants should follow the precise form specified by Item 601(b)(31) of Regulation S-K and include the required language on ICFR in the fourth paragraph of the certification when management's report on ICFR is included in the Form 10-K (this language may be omitted during the transition period for newly public companies to comply with Item 308(a) of Regulation S-K)



**Example SEC staff comment: Section 302 certifications**

It appears your officer certifications filed under Exhibits 31.1 and 31.2 do not include the language referring to ICFR that should appear in the introductory sentence of paragraph 4 of the section 302 certifications. Please note this additional language became effective for your first annual report required to contain management's report on ICFR and in all periodic filings thereafter.

Please revise your filings to include the correct certifications. We refer you to the guidance under C&DI for Regulation S-K, Question 246.13.

## Revenue recognition

### Identifying performance obligations

While most registrants have applied the guidance in ASC 606 since 2018, the SEC staff continues to focus on how they identify performance obligations, determine that they have satisfied performance obligations and disaggregate revenue in their disclosures.

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

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

Over the past year, the SEC staff continued to seek more details about how registrants identified performance obligations in contracts with customers. The SEC staff was especially interested in how registrants support their conclusions that certain promised goods and services are or are not separately identifiable.

**Example SEC staff comment: Identifying performance obligations**

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

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

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

### Satisfaction of performance obligations

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

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

#### **Example SEC staff comment: Satisfaction of performance obligations**

We note your disclosure that revenue is recognized when obligations under the terms of a contract are satisfied, which generally occurs with the transfer of control of your products. Please explain how and when such transfer of control will occur. Refer to ASC 606-10-25-24 and ASC 606-10-50-12(a). In addition, please tell us the nature of the post-shipment obligations that you may have and how you recognize the revenue in accordance with ASC 606-10-32-29.

### Disaggregated revenue disclosures

Under ASC 606-10-50-5, registrants are required to disclose disaggregated revenue information to illustrate how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors. While ASC 606 does not specify how revenue should be disaggregated, the implementation guidance in ASC 606-10-55-89 through 55-91 suggests categories for entities to consider, and the SEC staff has requested that registrants explain how they considered the implementation guidance when selecting the appropriate categories to disaggregate revenue.

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

#### **Example SEC staff comment: Disaggregated revenue disclosures**

We note your disaggregated revenue 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.

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.

## Segment reporting

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

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

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

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

### Identification of operating segments

The segment reporting guidance is based on a "management approach" (ASC 280-10-5). That is, segment disclosures should be consistent with a registrant's internal management reporting structure to enable investors to view the registrant similarly to the way management does. To support the management approach concept, the SEC staff has requested that registrants include a discussion of their internal structure or an organizational chart and the processes used to make operating decisions in their comment letter responses.

Identifying operating segments (ASC 280-10-50-1 through 50-9) is the first step in preparing segment disclosures. A critical element of this analysis is identifying the chief operating decision maker (CODM). To evaluate a registrant's identification of operating segments, the SEC staff often requests a description of the registrant's organizational structure and detailed information about employees who report directly to the CODM, including their roles and responsibilities and interactions with the CODM. The SEC staff also considers the basis on which budgets and forecasts are prepared and how performance objectives are evaluated, including how executive compensation is determined (e.g., performance criteria underlying compensation plans). This information helps the SEC staff understand how the CODM assesses performance and allocates resources and whether that is consistent with the operating segments identified.

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

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

When a registrant identifies only one operating segment, the SEC staff is more likely to challenge how decisions can be made about performance and resources for the company as a whole without evaluating discrete financial information on a more disaggregated basis.

#### **Example SEC staff comment: Identification of operating segments**

We note you have one operating segment, which consists of two business units. Your disclosure explains that this conclusion is based on the nature of products the company sells; an interrelated production and distribution model; the internal management structure; and information that is regularly reviewed by the chief executive officer, who is the CODM, for the purpose of assessing performance and allocating resources. Please provide us with your operating segment analysis under ASC 280-10-50-1. As part of your response, address the following:

- ▶ Tell us more about how your internal management structure is organized, including the title and role of each of the individuals who report to the CODM
- ▶ Identify and describe the role of the segment manager as contemplated by ASC 280-10-50-6 through 50-9
- ▶ Tell us how often the CODM meets with direct reports, the financial information the CODM reviews to prepare for those meetings, the financial information discussed in those meetings and any other personnel who attend those meetings
- ▶ Tell us whether there are individuals held specifically accountable for each of the two new business units
- ▶ Describe the contents of the discrete financial information that is reviewed by your CODM to allocate resources and assess performance, and indicate the frequency with which such information is prepared
- ▶ Describe the information regularly provided to the Board of Directors and how frequently it is prepared

#### **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 judgment, are:

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

The SEC staff often reviews the registrant's website, analyst presentations and information in public filings and raises questions if any of that information is inconsistent with the registrant's conclusion that aggregating operating segments is appropriate. For example, a discussion of diverging trends or differing results at two business lines could indicate that these 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.

#### **Example SEC staff comment: Aggregation of operating segments**

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

#### **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. 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 the performance of operating segments affected segment reporting conclusions.

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

You disclose that you operate as one operating segment, that your chief executive officer is your CODM and that he reviews financial information on a consolidated basis to evaluate performance. However, we note that the acquisition of ABC Corp materially altered your financial position and operations, such that your product and service offerings have expanded. Given the integration of ABC Corp into the entity post-acquisition and the realignments discussed in the filing, please address the following:

- ▶ Describe to us how the businesses and operations of ABC Corp have been integrated into the Company.
- ▶ Explain to us the factors you considered in concluding that you continue to operate as one operating segment pursuant to ASC 280-10-50.

- ▶ Tell us whether your product categories represent business units and describe the level of financial information available for each beyond net revenues.
- ▶ Describe to us the content of the information package that is provided to your CODM and how often he reviews the information.
- ▶ Provide us with an organizational chart of your senior management team that shows your CEO and each of his direct reports along with a brief description of their primary areas of responsibilities.

## Disclosures

### *Non-GAAP measures*

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

However, 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 and would require compliance with Item 10(e) if used anywhere outside the required ASC 280 reconciliation. 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.

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

Although you disclose that you changed your primary measure of segment profitability from gross profit to adjusted EBITDA, we note that you continue to present segment gross profit. If your CODM also uses this measure in assessing segment performance and deciding how to allocate resources, the reported measure should be that which management believes is determined in accordance with the measurement principles most consistent with those used in measuring the corresponding amounts in your consolidated financial statements. Please refer to ASC 280-10-50-28 and advise. Additional segment profit or loss measures may be presented outside of your financial statements and footnotes as non-GAAP measures if they comply with Regulation G and Item 10(e) of Regulation S-K.

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

### *Entity-wide disclosures*

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

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

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

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

The SEC staff also has 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., earnings calls).

## Goodwill and intangible assets

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

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

### Goodwill impairment analysis and disclosures

#### *Reporting units at risk of impairment*

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

To assist registrants in meeting this disclosure obligation, the SEC staff refers to disclosures in Financial Reporting Manual (FRM) Section 9510.3 that registrants should 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 staff guidance on COVID-19 disclosures also says registrants should consider whether they anticipate material impairments of goodwill or intangible assets.

#### **Example SEC staff comment: Reporting units at risk of impairment**

Given the recent and continuing decline of your market capitalization, please tell us if you performed an interim goodwill impairment test during the third quarter of fiscal year 2019. Also tell us if you consider, both on a current and historical basis, your sole reporting unit to be at risk of failing step one of the goodwill impairment test. Please note that a reporting unit is at risk of failing step one of the impairment test if it has a fair value that is not substantially in excess of carrying value. If your reporting unit is not at risk based on your most recent impairment test, please disclose this, as we believe it provides valuable information in assessing the sensitivity of your goodwill to future impairment. Alternatively, if your reporting unit is at risk of failing step one of the impairment test and a material impairment charge could occur, please disclose the following:

- ▶ The percentage by which fair value exceeded carrying value as of the date of the most recent impairment test. Please quantify for us this percentage as of your most recent quantitative impairment test.

- ▶ 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. The discussion regarding uncertainty should provide specifics to the extent possible (e.g., the valuation model assumes recovery from a business downturn within a defined period of time).
- ▶ A description of potential events and/or changes in circumstances that could reasonably be expected to negatively affect the key assumptions.

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

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

#### *Information on impairment analysis*

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

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

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

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



See the *COVID-19 observations* section for an example of an SEC staff comment on a registrant's disclosure that it tested goodwill and intangible assets for impairment and concluded that they were not impaired.

#### **Disclosure of critical accounting estimates**

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

- ▶ The accounting policies related to the goodwill impairment tests, including when the impairment test is performed, whether the optional qualitative assessment was performed for any reporting units, how reporting units are identified and aggregated, and how goodwill is assigned to reporting units
- ▶ How the fair value of each reporting unit was estimated, including the significant assumptions and estimates used

#### **Other intangible asset impairment**

An indefinite-lived intangible asset should be tested for impairment annually or more frequently (in accordance with ASC 350) if events or changes in circumstances indicate that the asset might be impaired. Long-lived assets to be held and used (including finite-lived intangible assets) are tested for impairment (in accordance with ASC 360) when factors exist that indicate that the carrying amount of a long-lived asset or asset group may not be recoverable.

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

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

#### **Example SEC staff comment: Other intangible assets**

We note that due to recent sales and profit declines, a significant portion of the excess between the fair value and the carrying value of certain of your trade names has eroded. To help investors more fully understand the potential impairment risk associated with these assets, please identify each material trade name with a fair value that is not substantially in excess of its carrying value and disclose the following:

- ▶ The carrying value and the percentage by which fair value exceeded carrying value
- ▶ The variables underlying your "relief from royalty" and/or "excess earnings" discounted cash flows such that changes in those variables may result in a decline in fair value significant enough to trigger an impairment charge for the trade name

## Other comment areas

### Contingencies

#### *Accounting for and disclosure of loss contingencies*

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

The SEC staff often questions whether a registrant has failed to make the required disclosure in the notes to the financial statements regarding reasonably possible losses, including reasonably possible losses in excess of the amount accrued. Registrants must disclose an estimate of the amount or range of such losses or indicate that an estimate cannot be made.

When registrants make disclosures about reasonably possible losses, the SEC staff generally has not objected to such disclosures being provided on an individual or aggregated basis, or a combination of the two. As a reminder, if a registrant cannot estimate the amount or range of reasonably possible loss, it should include a statement that such an estimate cannot be made.

However, the SEC staff has questioned how a registrant determined that an estimate of a reasonably possible loss or range of loss cannot be made. The SEC staff expects a registrant to undertake sufficient procedures to support its conclusion and may request additional information about the barriers to making an estimate and when the registrant expects those factors to be alleviated. For example, when a registrant discloses a loss contingency related to pending litigation, the SEC staff has asked for the registrant's history with similar legal matters and the age of the matter.

#### **Example SEC staff comment: Disclosure about reasonably possible losses**

We note your disclosure that it is reasonably possible that additional exposure to estimated future claims in excess of the amount accrued could have a material, unfavorable impact on the financial statements. If it is at least reasonably possible that a loss exceeding amounts already recognized may have been incurred and the amount of that additional loss would be material, either disclose the estimated additional loss, or range of loss that is reasonably possible, or state that such an estimate cannot be made. Refer to ASC 450-20-50-4.

The SEC staff expects disclosures about loss contingencies to evolve and include more quantitative information as a matter progresses. The SEC staff sometimes tracks this evolution in periodic filings and has issued multiple comments to a registrant on the same matter.

Finally, the SEC staff may challenge the timing of recorded losses or challenge the adequacy of earlier disclosures when a loss contingency appears to have been resolved unexpectedly.

### Cost of sales

The SEC staff continues to ask registrants to provide information supporting their conclusions on the appropriate presentation of revenue and cost of sales in the income statement. Specifically, the SEC staff focuses on the proper disaggregation of revenue in accordance with Rule 5-03(b)(1) of Regulation S-X and the improper presentation of gross profit when depreciation and amortization have been excluded from cost of sales under SAB Topic 11.B, *Depreciation and Depletion Excluded from Cost of Sales*.

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

**Example SEC staff comment: SAB Topic 11.B**

You present cost of goods sold exclusive of depreciation and amortization expense along with the subtotal, gross profit. Please tell us how your presentation complies with the guidance in SAB Topic 11.B, as gross profit appears to represent a figure for income before depreciation.

**Income taxes**

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

**Example SEC staff comment: Realizability of deferred tax assets**

We note that you have net deferred tax assets of \$XX million as of 31 December 2019 and that you have been in a three-year cumulative loss position since 31 December 2018. 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 2019. 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.

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

**Example SEC staff comment: Nature of reconciling items affected effective tax rates**

We note from your tax rate reconciliation that foreign income taxed at lower rates significantly impacted your effective tax rates. Please help us understand the nature of this reconciling item, including the primary taxing jurisdictions where your foreign earnings are derived and the relevant statutory rates in those jurisdictions. Please also discuss any incentivized tax rates you have been granted and briefly describe the factual circumstances of any tax holidays, the per-share effects of the tax holiday and the date upon which any special tax status terminates. Refer to ASC 740-10-50-12 and SAB Topic 11.C.

**Business combinations**

ASC 805 requires registrants to provide various disclosures associated with business combinations to help financial statement users evaluate the nature and financial effect of business combinations, including the pro forma information required by ASC 805-10-50-2(h) and information about the identification and determination of the fair value of acquired intangible assets.

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.

After an acquisition is completed, a registrant often needs to obtain additional information about facts and circumstances that existed at the acquisition date to complete its business combination accounting. In these situations, the SEC staff asks registrants to disclose the fact that the initial measurement of provisional items is incomplete and explain the nature of any additional information the registrant needs to finalize the business combination accounting. When registrants make adjustments during the measurement period to provisional amounts recognized for assets acquired or liabilities assumed in a business combination, the SEC staff has asked registrants to explain why such adjustments qualify as measurement period adjustments.

In addition, 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 to prepare the disclosures or to explain why the disclosures are not material.

**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

## Looking ahead

This year, we expect the SEC staff to continue to monitor how registrants address the accounting and reporting implications of the COVID-19 pandemic, including their accounting for past and future government relief. As we said in the *COVID-19 observations* section, while there were only a handful of publicly available comment letters relating to COVID-19 on periodic reports by our cut-off date of 30 June 2020, more have become public since then, and the number may continue to increase.

We also expect the staff to comment on how companies apply the new credit losses accounting standard and the new SEC disclosure rules related to significant business acquisitions and disposals, human capital resources and registered debt.

The sections below address some of these challenges and our expectations about SEC staff comments.

### **The new credit losses standard**

ASC 326 is effective for SEC filers (excluding smaller reporting companies) for years beginning after 15 December 2019. While the SEC staff has not yet issued many comments on the application of ASC 326, the comments it has issued have generally focused on the completeness of a company's accounting policy disclosures and on non-GAAP measures that exclude all or part of the effects of adoption.

### **Disclosure requirements for significant business acquisitions and disposals**

The SEC adopted final rules that amend its requirements for registrants to provide information about significant business acquisitions and disposals.

The rules were adopted as part of the SEC's disclosure effectiveness initiative, and we believe many registrants will benefit from the reduced costs and burdens of preparing financial information related to significant business acquisitions and disposals.

However, the amended rules will require registrants to change how they have evaluated significance in the past and the disclosures that were provided. For example, a registrant will need to consider the worldwide market value of its stock and its consolidated total revenue when performing the investment test and income test, respectively.

The amendments also eliminate the prescriptive criteria for making pro forma adjustments and replace them with three broad categories of adjustments. Two of the categories are required and similar to adjustments made in the past while the third category, management's adjustments, is optional and allows management to include forward-looking adjustments reflecting expected synergies as a result of a transaction.

The final rules are effective 1 January 2021, and earlier compliance is permitted. We expect the SEC staff to issue comments over the next year to evaluate registrants' compliance with these new rules. In particular, the new optional management's adjustments may draw scrutiny if registrants appear to be using them to predict significant savings resulting from a transaction.

Refer to our To the Point, [\*\*\*SEC streamlines disclosure requirements for acquisitions and disposals of businesses\*\*\*](#), for further discussions of the final rules.

### **Disclosure requirements about a registrant's business (including human capital resources), legal proceedings and risk factors**

The SEC adopted [\*\*final amendments\*\*](#) to its rules in Regulation S-K to streamline the disclosures registrants are required to make about business, legal proceedings and risk factors, and to add new requirements for disclosures about human capital resources. The amendments require disclosures about human capital resources and the related measures or objectives on which management focuses, if material. The amendments will be effective 30 days after publication in the Federal Register, and we expect the SEC staff to closely monitor registrants' compliance with the new rules.

Refer to our To the Point, [\*\*\*SEC streamlines some Regulation S-K disclosures and requires human capital disclosures\*\*\*](#), for further discussions of the final rules.

## Disclosure requirements for certain registered debt offerings

The SEC adopted final rules that amend the financial disclosure requirements for subsidiary issuers and guarantors of registered debt securities in Rule 3-10 of Regulation S-X. The SEC also amended the disclosure requirements for affiliates whose securities are pledged as collateral for registered securities in Rule 3-16 of Regulation S-X.

The rule changes are intended to encourage companies to conduct registered offerings of guaranteed and collateralized debt securities by making the requirements less burdensome while also providing investors with material information. For example, the amendments allow registrants to more broadly omit financial statements of subsidiary issuers and provide streamlined alternative disclosures.

The final rules are effective 4 January 2021, and earlier compliance is permitted. Over the next year, we expect to see some SEC staff comments intended to verify that registrants have adopted the new rules appropriately.

Refer to our Technical Line, [\*How to apply the SEC's new requirements for registered debt issued or guaranteed by subsidiaries\*](#), for further discussions of the final rules.

### Endnote:

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<sup>1</sup> [Disclosure of Environmental, Social, and Governance Factors and Options to Enhance Them](#), GAO-20-530, U.S. Government Accountability Office, 2 July 2020.

#### About EY

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## Appendix

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

### COVID-19 observations

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

### Non-GAAP measures

- ▶ Technical Line, [A closer look at the SEC staff's scrutiny of non-GAAP financial measures](#)
- ▶ [2019 SEC annual reports – Form 10-K](#)

### MD&A

- ▶ To the Point, [SEC issues guidance on disclosures about key performance indicators and other metrics in MD&A](#)
- ▶ [2019 SEC annual reports – Form 10-K](#)
- ▶ [2019 AICPA Conference on Current SEC and PCAOB Developments, Compendium of significant accounting and reporting issues](#)

### ICFR

- ▶ [2019 SEC annual reports – Form 10-K](#)
- ▶ [2019 AICPA Conference on Current SEC and PCAOB Developments, Compendium of significant accounting and reporting issues](#)
- ▶ Financial reporting developments, [Accounting changes and error corrections](#)
- ▶ SEC Reporting Update, [SEC issues guidance on cybersecurity](#)

### Revenue recognition

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

### Segment reporting

- ▶ Financial reporting developments, [Segment reporting](#)

### Goodwill and intangible assets

- ▶ Financial reporting developments, [Intangibles – goodwill and other](#)
- ▶ Financial reporting developments, [Fair value measurement](#)

#### Income taxes

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

#### Business combinations

- ▶ Financial reporting developments, *Business combinations*

#### Looking ahead

- ▶ Financial reporting developments, *Credit impairment under ASC 326*
- ▶ To the Point, *SEC streamlines disclosure requirements for acquisitions and disposals of businesses*
- ▶ To the Point, *SEC streamlines some Regulation S-K disclosures and requires human capital disclosures*
- ▶ Technical Line, *How to apply the SEC's new requirements for registered debt issued or guaranteed by subsidiaries*