

# SEC Reporting Update

## Highlights of trends in 2023 SEC staff comment letters

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### What you need to know

- ▶ The SEC staff issued significantly more comment letters to many more registrants about their disclosures in periodic SEC filings in the year ended 30 June 2023 than in the previous four years.
- ▶ Management's discussion and analysis and non-GAAP financial measures remained in the top two spots on our list of the most frequent topics the SEC staff addressed in comment letters.
- ▶ The SEC staff continued its more recent focus on climate-related disclosures, even as the SEC works to finalize a rule that would require more extensive disclosures.
- ▶ Segment reporting and revenue recognition remained the two most frequent accounting topics resulting in comments.
- ▶ With the SEC staff now issuing significantly more comment letters to many more registrants, it is important that registrants understand the process and effectively respond to the staff's comments.

### Overview

The Securities and Exchange Commission (SEC or Commission) staff issued nearly 60% more comment letters on periodic reports in the year ended 30 June 2023 than in the previous year, continuing the upward trend that began in 2022. This reverses multiple years of decline in the number of letters issued by the staff, with the volume of comment letters exceeding that of each of the past four years.

The number of registrants receiving SEC staff comment letters also increased sharply – by more than 70% – from the previous year, largely because the SEC staff issued more comment letters to smaller registrants (i.e., those with less than \$700 million in market capitalization). Management’s discussion and analysis (MD&A) and non-GAAP financial measures again took the top two spots on our list of topics the SEC staff addressed most frequently in comment letters in the year ended 30 June 2023. The SEC staff’s increased focus on MD&A and non-GAAP measures was a key reason for the overall increase in comment letters.

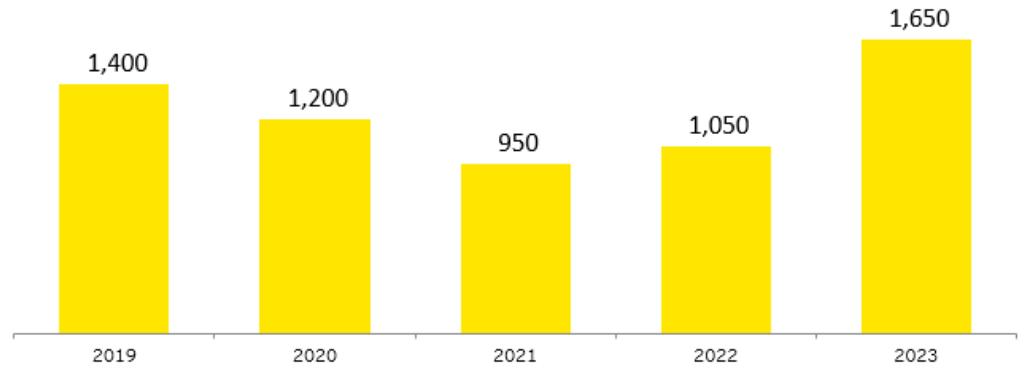
For the second year in a row, comments on climate-related disclosures made our list of frequent topics addressed by the SEC staff, and we expect the SEC staff to continue to scrutinize these disclosures, even as the SEC is expected to finalize a new rule<sup>1</sup> to require more extensive disclosures. On average, the comments on climate-related disclosures also continued to require more rounds of comments to resolve than comments on other topics on our list.

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.

## Significant increase in SEC staff comment letters

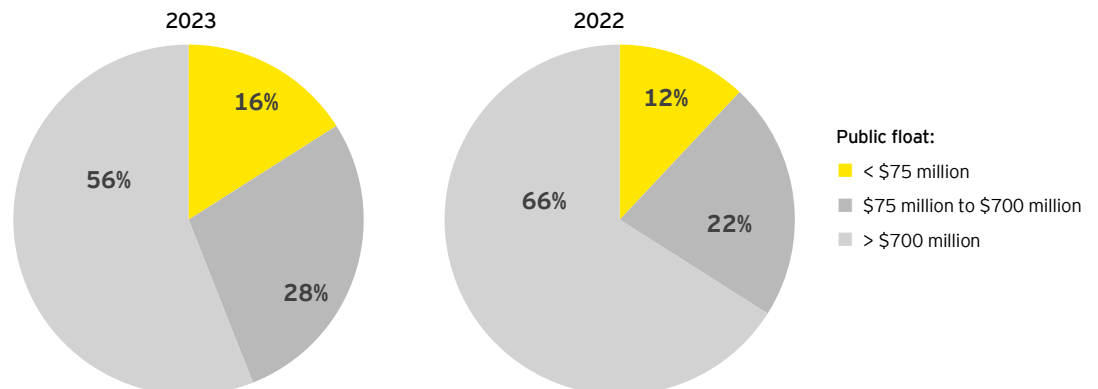
Both the volume of SEC staff comment letters and the number of recipients increased significantly in the year ended 30 June 2023.

### Number of SEC comment letters by year (rounded to the nearest 50)



**Source:** Audit Analytics – SEC UPLOAD comment letters related to Forms 10-K and 10-Q that were issued during the 12-month periods ended on 30 June each year and became publicly available by the date of our analysis, excluding those issued to special purpose acquisition companies (SPACs) and other blank check entities. Since the SEC publicly releases comment letters no earlier than 20 business days after the completion of its reviews, our analysis for the latest year includes letters that were issued by 30 June and were publicly available by 31 August 2023.

### 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 2023 and 30 June 2022, excluding SPACs and other blank check entities.

The SEC staff must review the filings of registrants at least once every three years, using a risk-based approach to select registrants' periodic filings for review. While this results in the SEC staff reviewing the filings of larger registrants more frequently than those of smaller registrants, the SEC staff has increased its focus on smaller registrants (i.e., those with less than \$700 million in market capitalization) over the past two years.

### Most frequent comment areas

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

The number of comment letters addressing each of these topics increased from the previous year, with the volume of letters addressing MD&A and non-GAAP measures rising by more than 100% and 50%, respectively.

Climate-related disclosures, which before last year had not been a focus area of the SEC staff, remained on the list of top areas of comment, and the number of registrants that received a letter increased by approximately 25% from the previous year. Although the average number of rounds of letters required to resolve the climate-related comments decreased slightly, these comments continued to require more rounds to resolve than comments on other topics on our list. The climate-related comments in 2023 continued to be consistent with the sample letter the SEC staff issued in 2021 on this topic.

The following list of most frequent comment areas includes areas for which a significant number of registrants received a comment on the topic. The frequency with which the topic was included in letters received by registrants is also reflected below.

Comment area	2023		
	Ranking for 12 months ended 30 June <sup>1</sup>	Comment area received as a percentage of registrants receiving comment letters	Average letters per registrant <sup>3</sup>
Management's discussion and analysis (MD&A) <sup>2</sup>	1	39%	1.2
Non-GAAP financial measures	2	39%	1.3
Segment reporting	3	14%	1.2
Revenue recognition	4	10%	1.2
Climate-related disclosures	5	6%	1.9

<sup>1</sup> These rankings are based on topics assigned by research firm Audit Analytics for SEC comment letters issued to registrants with a market capitalization of \$75 million or more on Forms 10-K and 10-Q from 1 July 2022 through 30 June 2023, excluding comment letters issued to SPACs and other blank check entities. In some cases, individual SEC staff comments are assigned to multiple topics.

<sup>2</sup> For the year ended 30 June 2023, this category includes comments on MD&A topics, excluding climate-related disclosure matters, in order of frequency: (1) results of operations (58%), (2) liquidity matters (23%), and (3) various other matters, including key performance indicators and critical accounting estimates (19%). Many registrants received MD&A comments on more than one MD&A topic.

<sup>3</sup> This represents the average number of comment letters (or rounds of comments) the SEC staff issued for each topic to resolve its concerns.

## Responding to a comment letter

With the SEC staff now issuing significantly more comment letters to many more registrants, it is important that registrants understand the process and effectively respond to the staff's comments.

### 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 preliminarily concluded that the disclosures must change. Registrants receiving comment letters should generally view the process as an opportunity to educate the staff about how they arrived at their disclosure or accounting conclusion, rather than an indication that revisions are necessary. In many cases, comments are resolved once the SEC staff has gained a full understanding of a registrant's facts and circumstances and obtained sufficient insight into management's judgments that led to the disclosure or accounting conclusion.

The SEC staff often requests a written response to its comment letters within 10 business days. It is common for registrants to need more time to sufficiently respond to the comments. In those cases, registrants should contact the SEC staff to obtain an extension, which is generally granted. A registrant also may consider contacting the SEC staff if it needs clarification about a comment or to obtain some informal feedback regarding its approach to responding. As a matter of practice, the SEC staff will not clear or resolve outstanding comments in a conference call.

As a reminder, all comment letters, including registrants' responses, become part of the public record as they are posted on the SEC's website once they are resolved. Registrants should file all response letters on EDGAR, redacting any specific information for which they are seeking confidential treatment.

Registrants should also be aware that if the SEC staff doesn't comment on a particular matter, that does not mean the SEC staff concurs with their judgments. That is, the SEC staff may comment in the future about a disclosure it hasn't questioned in the past.

### Leading practices

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

Registrants should take the time needed to provide a comprehensive initial response to reduce the number of rounds of comments necessary to reach resolution with the SEC staff. When responding to a comment letter, a registrant may 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. To resolve any comments in a timely fashion, a registrant should draft a response that:

- ▶ Reflects the input of all appropriate internal personnel and outside advisers (such as legal counsel and independent auditors), who should be engaged early in the process to make sure the response is complete and accurate
- ▶ Focuses on the question(s) the SEC staff asked and provides a complete response addressing all aspects of the comment, citing authoritative literature and related guidance wherever possible

- ▶ Addresses materiality if the SEC staff asks why a particular disclosure did not appear in a filing or if a registrant believes the accounting for an item is immaterial, providing a robust explanation of the quantitative and qualitative factors the registrant considered as part of its materiality analysis
- ▶ Addresses the registrant's unique facts and circumstances and judgments made in applying the relevant guidance
- ▶ Avoids overreliance on other registrants' responses on similar topics because there may be differences in facts that are not readily apparent

### ***Disclosure revisions***

Registrants may decide to revise their disclosures in future filings as a result of the comment letter process. Before proposing a revised disclosure, registrants should make sure they are capable of producing the financial or other information necessary to provide the revised disclosure.

In its response to a comment letter, the registrant should indicate where in the filing the disclosure revisions will be made and, if possible, include the proposed language for a revised disclosure. If the proposed revised disclosure language is included, the registrant should also indicate in its response that the facts and circumstances may change in a way that may require a different disclosure.

If the registrant's response will not include the proposed language for a revised disclosure, the registrant should be prepared to provide it because the SEC staff may not accept a statement that the registrant will revise its disclosure in future filings without seeing the proposed revisions.

### **Disclosure requirements**

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

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

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

### **Management's discussion and analysis**

While SEC staff comments address various aspects of MD&A disclosure sections, the majority of comments are focused on disclosures about results of operations. Many related to a registrant's lack of sufficiently detailed disclosures about the reasons for material period-to-period changes in a registrant's financial statement line items. The SEC staff has been asking registrants about the effects of macroeconomic factors, including inflation, interest rates and supply chain issues.

## 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 a registrant's analysis of changes in revenue, the SEC staff has been commenting on other line items or subtotals, such as cost of goods sold; gross profit; and selling, general and administrative expenses.

The SEC staff's requests for more details about results of operations include requests that registrants:

- ▶ Discuss the effects of each factor that contributed to material period-to-period changes in quantitative and qualitative terms, including the underlying business or economic factors and any material offsetting factors
- ▶ Describe and discuss the impact of any unusual or infrequent events or transactions, including events that have been the subject of news accounts but have not been disclosed by the registrant in an SEC filing, or any significant changes in the economic environment that materially affected income from continuing operations
- ▶ Provide insight into significant components of revenue or expense necessary to understand the results of operations (e.g., revenues attributable to significant new customers, impact of changes in pricing and quantity, changes related to acquisitions versus organic growth, 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, expenses or income from continuing operations (e.g., the impact of higher interest rates)
- ▶ Discuss reportable segment information needed to understand their results of operations

When a registrant discloses that two or more factors contributed to a material period-to-period change in a financial statement line item or subtotal, the SEC staff often reminds the registrant that Item 303 of Regulation S-K requires disclosure of the reasons for material changes, in quantitative and qualitative terms, for each factor.

### **Example SEC staff comment: Results of operations – disclosure of quantitative and qualitative factors (gross profit)**

In your analysis of "gross profit" for each period presented, you state sales growth is a factor for gross profit increases. Please explain to us and disclose the extent of this effect. Since, presumably, cost of sales also increases with sales increases, discuss the relative impact of each on your gross profit margins. Also, please explain to us and disclose the reasons why gross profit margins changed in the periods presented. If product mix contributes to gross profit margin changes, discuss the extent and the products that are the primary contributors and why (e.g., "product A provides more/less margin because ..."). If inflation has affected your costs and margins, explain the relative effect of each. Refer to Item 303 of Regulation S-K and Section III.B.4 of Release No. 33-8350 for guidance.

The SEC staff continued to request that registrants identify and quantify the impact of each factor that has a material effect on results of operations, including those that offset one another.

**Example SEC staff comment: Results of operations – disclosure of quantitative and qualitative factors (revenue)**

Please expand your discussion and analysis to address changes in revenues with reference to both volumes and prices to comply with Item 303(b)(2)(iii) of Regulation S-K. For example, quantify the volumes sold for each period, address the reasons for material changes in volumes, and provide similar commentary on the effects of material changes in unit prices as may pertain to revenues reported for both of your reportable segments.

The SEC staff has also requested that registrants provide certain forward-looking information about known trends and uncertainties. Disclosure is required for trends and uncertainties that are “reasonably likely” to have a material effect on revenues or income from continuing operations. In evaluating this requirement, the registrant must determine whether the trend or uncertainty is reasonably likely to come to fruition; if it isn’t, no disclosure is required. If the registrant cannot make this determination, it must assume that the trend or uncertainty is reasonably likely to come to fruition and provide disclosure in MD&A, unless it is not reasonably likely to have a material effect.

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

You disclose you have been impacted by negative macroeconomic trends, including a condensed labor market, wage inflation, global supply chain issues and inflation affecting your revenues and underwriting. Please expand your disclosure to identify the principal factors contributing to these issues and clarify the resulting impact on you. Additionally, disclose any known trends or uncertainties regarding these issues that are reasonably likely to have a material impact on your cash flows, liquidity, capital resources, cash requirements, financial position or results of operations. Refer to Item 303(b)(2)(ii) of Regulation S-K.

## How we see it

Given the persistence of inflation and the likelihood that interest rates will remain elevated, we expect to see a continued focus from the SEC staff on macroeconomic factors. Registrants should carefully evaluate how economic conditions may affect their business and provide disclosures related to these matters in sufficient detail.

***Significant components of financial condition and results of operations***

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

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

We note that you identify several reasons for changes in your operating expenses in the various segment-oriented disclosures, though do not separately quantify the impact of each driver or component, e.g., changes attributed to materials and supplies expense, payroll costs, and utility costs. Under Item 303(b) of Regulation S-K, when the consolidated financial statements reflect material changes from period to period in one or more line items, or where material changes within a line item offset one another, you are required to describe the underlying reasons in quantitative and qualitative terms. Please revise to quantify the impact of each factor or component associated with material changes, including the impact of inflation associated with any material changes.

### *Key financial and operating metrics*

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

When a registrant uses a key metric to discuss operating results in MD&A, the SEC staff expects it to appropriately classify the information (i.e., as a non-GAAP measure or a KPI) and follow the appropriate guidance on presentation and disclosures (e.g., [the Commission's guidance](#) for KPIs and Item 10(e) of Regulation S-K for non-GAAP measures). The SEC staff also said that it would generally expect, based on the facts and circumstances, the following additional disclosures to accompany the metric:

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

If there are estimates or assumptions underlying the metric or its calculation, the registrant should evaluate whether disclosure of this information is necessary for the disclosure of the metric not to be misleading.

If a registrant changes the method it uses to calculate or present a metric from one period to another, the registrant should consider disclosing, 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
- ▶ Other differences in methodology and results that would reasonably be expected to be relevant to an understanding of the registrant's performance or prospects

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

In addition to commenting on the additional disclosures required to accompany a metric disclosed in MD&A, the SEC staff often questions a registrant's use of KPIs in earnings releases or investor presentations if it doesn't discuss the KPIs in MD&A.

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

The SEC staff has requested that registrants include KPIs discussed in earnings releases and investor presentations in their MD&A.



**Example SEC staff comment: KPIs without appropriate context**

We note that you present certain metrics including annual recurring revenue (ARR), net revenue retention from existing customers, and the number of customers with ARR greater than \$XM. Please tell us and revise future filings to disclose the reasons why the metric is useful to investors, how management uses the metric, and if there are estimates or assumptions underlying the metric or its calculation; disclosure of such items if it's necessary for the metric not to be misleading. Additionally, in future filings, please revise to provide more quantitative and qualitative details discussing how changes in your KPIs impacted your results of operations as well as any other known trends. See guidance in SEC Release No. 33-10751 *Commission Guidance on Management's Discussion and Analysis of Financial Condition and Results of Operations*.

**Critical accounting estimates**

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

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

The SEC staff has noted that registrants' disclosures about critical accounting estimates often are too general and should provide a more robust analysis than what is in the significant accounting policies note to the financial statements. While that note generally describes the method used to apply an accounting principle, the discussion in MD&A should address the measurement uncertainties involved in applying the principle at a given time.

The rules clarify that the critical accounting estimates disclosure must supplement, not duplicate, the disclosures in the financial statements. Therefore, registrants can consider including in MD&A a cross-reference to the footnote disclosure about significant accounting policies but should not repeat information that is already included in that note. MD&A disclosures should be expanded as necessary to address the following, if material:

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

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

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

**Example SEC staff comment: Enhanced disclosure**

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

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

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

**How we see it**

We believe registrants should continually reassess which estimates they identify as critical accounting estimates, given the significant level of judgment involved. That is, registrants need to consider the impact of any changes in the level of judgment and estimation uncertainty and the materiality of the estimate's reasonably likely impact on the financial statements.

**Liquidity and capital resources**

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

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

Registrants must also describe their material cash requirements, their general purpose and the anticipated source of the funds needed to satisfy them. We have also observed the SEC staff comment on cash held in foreign jurisdictions and the impact on a company's liquidity when a company has significant foreign operations.

Further, although registrants are no longer required to include a contractual obligations table, they are required to discuss known contractual (e.g., lease obligations) and other obligations (e.g., purchase obligations) on both a short-term and long-term basis. This requirement is intended to make sure that the elimination of the contractual obligations table does not result in a material loss of information for investors. Registrants' disclosures should clearly reflect the categories of obligations that are meaningful in light of their capital structure and business. Registrants are not precluded from continuing to present required disclosures in a tabular format, as long as the information is reflected in a manner that is appropriate for their business.

Item 303 of Regulation S-K also requires that a registrant discuss known material trends, demands, commitments, events or uncertainties that are reasonably likely to affect (either favorably or unfavorably) liquidity or capital resources.

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

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

Your analysis of changes in operating cash flows references net results, noncash charges and working capital. Note that references to these items may not provide a sufficient basis to understand how operating cash was affected between periods. Your analysis should discuss factors that affected operating cash and reasons underlying these factors. In doing so, explain the underlying reasons and implications of material changes between periods to provide investors with an understanding of trends and variability in cash flows. Refer to the introductory paragraph of section IV.B and paragraph B.1 of Release No. 33-8350 for guidance. Please revise your disclosure as appropriate.

The SEC staff requests enhanced disclosures of changes in operating cash flows and the underlying reasons for and implications of material changes.

When there is a heightened risk of debt default (e.g., adverse trends in cash flows or operating results, recent covenant waiver requests, a significant amount of debt maturing within 12 months) or when management has concluded it is reasonably likely that covenants will be violated in the future, 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 violations, including how long any waivers apply, and a description of the covenant
- ▶ The likelihood of violating debt covenants in the future

### **Non-GAAP financial measures**

The SEC staff continues to focus on non-GAAP financial measures in comment letters. The staff has long expressed concerns about the improper use of non-GAAP measures in filings and in earnings releases and has published non-GAAP Compliance and Disclosure Interpretations (C&DIs) addressing the presentation and disclosure of non-GAAP measures, most recently updated in December 2022.

Many of the SEC staff's comments focused on the latest updates to the C&DIs. For example, the staff has asked registrants whether operating expenses are "normal" or "recurring" and, therefore, whether their exclusion from a non-GAAP financial measure could be misleading based on C&DI Question 100.01. The staff has also asked about non-GAAP adjustments to

both revenue and expenses that could have the effect of changing the recognition and measurement principles required by GAAP, thereby rendering them “individually tailored” and potentially resulting in a misleading measure based on C&DI Question 100.04.

More generally, the SEC staff continues to focus on whether non-GAAP financial measures reported by registrants comply with Item 10(e) of Regulation S-K and the SEC staff’s related C&DIs, including whether certain performance metrics 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.

Most of the SEC staff comments have focused on registrants’ use of non-GAAP measures in earnings releases and SEC filings. However, the SEC staff also reviews other communications (e.g., websites, investor presentations, earnings calls transcripts) that may contain non-GAAP measures.

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

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

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

The SEC staff often requests additional information and explanation from a registrant when a measure may meet the definition of a non-GAAP measure in Item 10(e) but is not identified as a non-GAAP measure. The staff also often asks registrants to clearly label and describe non-GAAP measures and related adjustments in sufficient detail so investors can understand all material components and distinguish them from GAAP measures.

The staff continues to issue comments when a registrant’s calculation of a non-GAAP measure appears different from the typical calculation of the measure. For example, the staff has asked registrants that call non-GAAP measures calculated as something other than cash flows from operating activities, less capital expenditures, “free cash flow” to change the title to “adjusted free cash flow” or something similar.

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

Your calculation of free cash flow differs from the typical calculation of this measure (i.e., cash flows from operations less capital expenditures). In order to avoid potential confusion, please revise the title of your non-GAAP measure to “adjusted free cash flow” or something similar. Refer to Question 102.07 of the Non-GAAP Compliance and Disclosure Interpretations. Also, revise the title of unlevered free cash flow accordingly.

The staff has also issued comments when a registrant inappropriately excludes charges or liabilities that require or may require cash settlement from a non-GAAP liquidity measure (e.g., when adjusted free cash flow excludes a cash-settled payment for litigation).

**Example SEC staff comment: Exclusion of cash-settled charges from a non-GAAP liquidity measure**

We note that your adjusted free cash flow measure excludes amounts related to the Russia-Ukraine conflict, which appear to be cash costs. Please tell us how you considered Item 10(e)(1)(ii)(A) of Regulation S-K, which prohibits the exclusion of liabilities or charges that require, or may require, cash settlement from a liquidity measure or revise to remove such adjustment.

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

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

***Prominence of non-GAAP measures***

The SEC staff believes that, to comply with the requirement to present the comparable GAAP measure with equal or greater prominence, a registrant needs to present and provide any discussion and analysis of the GAAP measure before that of the related non-GAAP measure. For this reason, GAAP measures must precede the non-GAAP measures in the required reconciliations. C&DI Question 102.10(a) provides additional examples of instances in which non-GAAP measures are considered by the staff to be more prominent than the comparable GAAP measures, including presenting an income statement of non-GAAP measures, or a ratio where a non-GAAP financial measure is the numerator and/or denominator without also presenting the ratio calculated using the most directly comparable GAAP measure with equal or greater prominence.

Consistent with this guidance, the SEC staff has objected to registrants presenting a full non-GAAP income statement as a form of reconciliation because this gives the non-GAAP information undue prominence.

**Example SEC staff comment: Prominence of non-GAAP measures**

We note you disclose non-GAAP gross margin, a non-GAAP financial measure, without its most directly comparable GAAP financial measure, which is a GAAP gross profit margin. Please revise to disclose the most directly comparable GAAP financial measure with equal or greater prominence. This comment also applies to the non-GAAP gross margin presented in the earnings release furnished with your Item 2.02 Form 8-K. Refer to Question 102.10(a) of the Compliance and Disclosure Interpretations on Non-GAAP Financial Measures and Item 10(e)(1)(i)(A) of Regulation S-K.

***Reconciliation***

The SEC staff has asked registrants to revise their presentation when a non-GAAP reconciliation does not start with the applicable GAAP measure as noted in the updated C&DI Question 102.10(b) because that presentation would give undue prominence to a non-GAAP measure.

**Example SEC staff comment: Reconciliation**

Your “Diluted EPS before charges/gains” non-GAAP reconciliation begins with the non-GAAP measure and, therefore, presents the non-GAAP measure more prominently than the comparable GAAP measure. We note similar non-GAAP prominence issues with the reconciliations in your Form 8-K furnished. In future filings, please ensure all non-GAAP reconciliations start with the applicable GAAP measure. Refer to Instruction 2 to Item 2.02 of Form 8-K, Item 10(e)(1)(i)(A) of Regulation S-K, and Question 102.10(b) of the Compliance and Disclosure Interpretations on Non-GAAP Financial Measures.

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

**Example SEC staff comment: Reconciliation of forward-looking non-GAAP measures**

Expand your disclosure regarding forward-looking non-GAAP measures where you are relying on the exception per Item 10(e)(1)(i)(B) of Regulation S-K to clearly disclose your reliance on the exception and to identify the information that is unavailable and its probable significance in a location of equal or greater prominence. See Question 102.10(b) of the Compliance and Disclosure Interpretations regarding Non-GAAP Financial Measures.

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.

***Usefulness and purpose of the disclosure***

The SEC staff has also asked registrants to clarify and expand their disclosures to discuss why a particular measure is useful to investors and, to the extent material, any additional purposes for which management uses it. Often, the disclosures that the SEC staff asks about are boilerplate or too general to help readers understand how they should use a particular measure. If a registrant cannot adequately explain why a measure is useful, the SEC staff may consider that as an indication that the measure may be misleading.

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

We note you disclose Adjusted EBITDA as a non-GAAP financial performance measure. Expand your disclosure to explain how management uses this measure and why you believe it provides useful information to investors regarding your performance pursuant to Item 10(e)(1)(i)(C) and (D) of Regulation S-K.

**Other areas of comment on non-GAAP financial measures*****Exclusion of normal, recurring cash operating expenses***

In C&DI Question 100.01, 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 C&DI describes how the SEC staff considers whether operating expenses are “normal” and “recurring.” The C&DI notes that, in making the determination of whether an operating expense is “normal,” the staff considers how the nature and effect of non-GAAP adjustments relate to the company’s operations, revenue-generating activities, business strategy and regulatory environment. Further, it states the staff’s view that an operating expense that occurs repeatedly or occasionally, including at irregular intervals, is recurring.

The SEC staff has objected to non-GAAP adjustments when the staff views certain expenses as normal, recurring cash operating expenses.

In the past year, the SEC staff has objected to a variety of adjustments, including:

- ▶ Costs to be a public company (e.g., liability insurance for public company directors and officers, investor relation costs, listing fees)
- ▶ Certain legal and regulatory expenses
- ▶ Store or restaurant pre-opening (including geography entry costs) and closing costs and rent expense
- ▶ Up-front and contingent milestone payments in connection with pharmaceutical collaborative and licensing arrangements, or research and development (R&D) arrangements
- ▶ Acquired in-process research and development (IPR&D) assets charged to R&D costs in an asset acquisition in the pharmaceutical industry

**Example SEC staff comment: Excluding normal, recurring cash operating expenses**

Please tell us how the adjustments for store pre-opening expenses, store closing expenses and nonrecurring costs to arrive at Adjusted EBITDA are in compliance with Question 100.01 of the Compliance and Disclosure Interpretations on Non-GAAP Financial Measures.

We have also seen the SEC staff comment on non-GAAP adjustments related to frequent restructuring and acquisition-related costs. Although the SEC staff has said that restructuring costs have not typically been found to be “normal” in their assessed fact patterns, it has emphasized that registrants should consider how restructuring relates to the factors noted in C&DI Question 100.01 (i.e., operations, revenue-generating activities, business strategy, industry and regulatory environment) to make that determination. If a registrant has frequent business acquisitions and restructuring costs over successive quarters or years, the SEC staff may ask about the facts and circumstances supporting an adjustment for what could be a recurring cost. The staff also may ask registrants to explain and quantify the components of these adjustments.

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

Refer to your non-GAAP financial measures: net income from continuing operations excluding special items, earnings per share from continuing operations excluding special items, and operating income excluding special items. It appears that the reconciliations for these non-GAAP financial measures include an adjustment for “restructuring expense,” which you have incurred every year since 2012. Please tell us your consideration as to whether these charges represent normal, recurring cash operating expenses necessary for your core operations. Refer to Question 100.01 of the Compliance and Disclosure Interpretations on Non-GAAP Financial Measures. Please note that this comment also applies to the non-GAAP measures presented in your Form 10-Q and Item 2.02, Form 8-K.

The staff has also challenged adjustments for implementation costs related to long-term strategic investments in technology (e.g., replacement of an enterprise resource planning system over several years).

***Individually tailored accounting principles***

Significant judgment is required to determine whether a measure of a registrant’s historical or future financial performance, financial position or cash flows may apply tailored accounting principles. C&DI Question 100.04 provides guidance on non-GAAP measures that the SEC staff believes could be misleading and includes a non-exhaustive list of examples of non-GAAP

adjustments to both revenue and expenses that could have the effect of changing the recognition and measurement principles required by GAAP and, therefore, could be misleading. For example, it would be misleading to present a non-GAAP measure of revenue that deducts transaction costs as if the company acted as an agent in the transaction, when gross presentation as a principal is required by US GAAP.

While the SEC staff has historically focused on adjustments to revenue, its current approach is broader and includes challenging other ways registrants modify GAAP recognition and measurement principles to calculate non-GAAP measures as described in C&DI 100.04.

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

**Example SEC staff comment: Individually tailored accounting principle**

Your non-GAAP adjustment for deferred tax valuation allowance removes the effects of the valuation allowance from your GAAP tax provision and appears to change your income taxes recognition method, resulting in an individually tailored accounting. Please remove this adjustment from your reconciliation of Net Income (Loss) Attributable to XXX Corp. Shareholders. Refer to Question 100.04 of the Non-GAAP Financial Measures Compliance and Disclosure Interpretations.

## How we see it

There are no established criteria for identifying an individually tailored accounting principle. Registrants should consider objections made by SEC staff to non-GAAP measures in the comment letter process to determine whether they should make any adjustments to their own measures.

The SEC staff has continued to emphasize the importance to investors of revenue determined in accordance with US GAAP and said more registrants are inappropriately presenting non-GAAP measures with the word "revenue" in the title. For example, presenting a measure entitled "gross revenue" before discounts or other incentives that reduce revenue under US GAAP would not be appropriate. However, the staff said a registrant could present such a measure and call it "billings" if it is consistent with amounts invoiced to customers. In that case, the non-GAAP rules would not apply because the metric would be considered a KPI.



The staff also said some registrants have presented as “net revenue” a measure calculated by adding back a portion of the cost of revenue. A registrant that presents such a measure should make it clear that it is a margin calculation, and it should not use the term “revenue” in the title. The registrant should also reconcile the measure to gross margin as defined in the Financial Accounting Standards Board (FASB) Master Glossary. If a registrant does not present gross margin in its financial statements, it must calculate and disclose it to meet the requirement to reconcile non-GAAP measures with GAAP measures.

### How we see it

Registrants that receive questions from the SEC staff about non-GAAP measures should be prepared to revise their future filings, earnings releases, earnings guidance and other documents containing the measures, including revising any comparative data. When the SEC staff concludes that a non-GAAP measure is misleading, it expects the registrant to discontinue using the measure or the portion of the measure that is misleading for all periods presented.

## Segment reporting

The SEC staff continues to focus on how registrants apply the guidance in Accounting Standards Codification (ASC) 280, *Segment Reporting*, including:

- ▶ 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 that say in an SEC filing the basis for identifying operating segments is something other than product or service lines (e.g., geography) but publicly disclose information elsewhere that suggests that management uses financial information by product or service lines to make decisions and allocate resources.

### Identification of operating segments

The segment reporting guidance is based on a “management approach” (ASC 280-10-5). That is, segment disclosures should reflect a registrant’s internal reporting structure to enable investors to view the company similarly to the way management does.

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, in addition to information about how operating decisions are made (e.g., allocation of resources).

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

The SEC staff also considers the basis on which budgets and forecasts are prepared and how performance objectives are evaluated, including how executive compensation is determined (e.g., performance criteria underlying compensation plans). This information helps the SEC staff understand how the CODM assesses performance and allocates resources, and whether that is consistent with the operating segments identified.

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

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

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

You state that your operations constitute one operating and reportable segment. However, we note that you discuss revenue, costs and measures by region and product in the Forms 10-K and 10-Q. We further note that you present a managing director for each region on your website. As such, please address the following:

- ▶ Provide us with details about your management structure and how your company is organized
- ▶ Describe the role of your CODM and each of the individuals reporting to the CODM
- ▶ Describe the role of each of your regional managing directors
- ▶ Describe the key operating decisions, who makes these decisions, how performance is assessed and how resources are allocated within your business
- ▶ Tell us how often the CODM meets with her direct reports, the financial information the CODM reviews in conjunction with those meetings and the other participants at those meetings
- ▶ Explain how budgets are prepared, who approves the budget at each step of the process, the level of detail discussed at each step and the level at which the CODM makes changes to the budget
- ▶ Describe the basis for determining the compensation for each individual who reports to the CODM

#### **Aggregation of operating segments**

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

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

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

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

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

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

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

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

We note you operate within a single reportable segment. Disclose the basis for your conclusion of having one reportable segment, including a discussion of whether your different revenue streams represent separate operating segments. If operating segments have been aggregated, please tell us the basis for such aggregation and also tell us your consideration of the disclosure requirements in ASC 280-10-50-21. In your response, specifically address how the different information disclosed on your earnings calls impacted your operating and reportable segment assessments.

### **Disclosures**

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

#### ***Measure of profit or loss for reportable segments***

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

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

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

### How we see it

To address investors' requests for companies to provide more information about financial performance at the segment level, the FASB is finalizing amendments to the guidance in ASC 280 to require all public entities, including those with a single reportable segment, to disclose information about significant segment expenses. The current FASB proposal would also allow entities to report multiple measures of segment profit or loss if the CODM uses more than one measure to allocate resources and assess performance. The FASB recently completed redeliberations and expects to issue a final Accounting Standards Update soon.

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.

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

We note you disclose gross profit and operating income for each of your reportable segments. Considering you disclose more than one measure of segment profit or loss, please revise to disclose only one measure that you believe is determined in accordance with the measurement principles most consistent with those used in measuring the corresponding amount in the consolidated statements of operations. Refer to ASC 280-10-50-28. In addition, to the extent that the measures that are not identified as the segment measure of profit or loss under ASC 280 are presented outside the consolidated financial statements, please label them as non-GAAP financial measures and provide the required disclosures under Item 10(e) of Regulation S-K.

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

#### Entity-wide revenue disclosures

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

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

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

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

**Example SEC staff comment: Entity-wide revenue disclosures**

We note your disclosure of net sales by geographic area on page XX and net sales by major customer group for each segment on page XX. Please disclose revenues from external customers for each product and service or each group of similar products and services as required by ASC 280-10-50-40 or tell us and disclose why it is impracticable to do so.

**Reconciliations**

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

**Example SEC staff comment: Segment disclosures on reconciliations**

Please reconcile segment gross profit to consolidated income (loss) before income taxes in accordance with ASC 280-10-50-30 to 32. Your reconciliation should identify and describe all significant reconciling items, including, but not limited to, elimination of intersegment revenue. Provide us with your proposed future presentation.

## Revenue recognition

### Disaggregated revenue disclosures

Under ASC 606-10-50-5, registrants are required to disclose disaggregated revenue information to illustrate how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors. While ASC 606, *Revenue from Contracts with Customers*, does not specify how revenue should be disaggregated, the implementation guidance in ASC 606-10-55-89 through 55-91 suggests categories for entities to consider.

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

Over the past year, the SEC staff continued to seek more details about how registrants have considered the implementation guidance when selecting categories of revenue.

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

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

Given the mix of revenue sources in the measure, along with various disclosures provided elsewhere in your filing, it is unclear why each component would not have been separately reported pursuant to ASC 606-10-50-5 and ASC 606-10-55-89 through 55-91 in order to accurately depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors.

Tell us how you have considered the disclosures referenced in each of the following points in your application of the aforementioned guidance. It should be clear how you have considered the emphasis placed on the various components and differences in the economic and risk profiles in determining that no further disaggregation would be required, if this is your view.

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

In addition, ASC 606-10-50-6 requires an entity to explain the relationship between the disclosure of disaggregated revenue and revenue information that is disclosed for each reportable segment. Registrants should review their disclosures to verify that they meet this disclosure requirement. For further discussion on segment disclosures, including entity-wide revenue disclosures, please refer to the segment reporting section of this publication.

**Identifying performance obligations**

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

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

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

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

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

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

### Satisfaction of performance obligations

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

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

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

Please clarify the extent to which your revenues are recognized at a point in time or over time. Please tell us how you determined the contracts that qualify for point-in-time recognition and those that qualify for over-time recognition. Refer to ASC 606-10-25-23 to 25-30.

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

### Climate-related disclosures

The SEC staff's comments on climate-related disclosures continue to align with the [sample comment letter](#) that the SEC's Division of Corporation Finance posted on the SEC website in September 2021 to illustrate the types of comments it had begun issuing to registrants about their compliance with the [Commission's 2010 guidance regarding disclosure related to climate change](#).

That guidance in Regulation S-K says registrants may need to make disclosures about climate-related matters in the description of the business (Item 101), discussion of legal proceedings (Item 103), risk factor disclosures (Item 105) and/or MD&A (Item 303). Securities Act Rule 408 and Exchange Act Rule 12b-20 also require a company to disclose any other material information necessary to make the required disclosures not misleading.

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

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

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

### **Impact of legislation, regulation, international accords and litigation**

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

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

#### **Example SEC staff comment: Climate-related legislation, regulation and international accords**

There have been significant developments in federal and state legislation and regulation and international accords regarding climate change that you have not discussed in your filing. Please revise your disclosure to identify material pending or existing climate change-related legislation, regulations and international accords and describe any material effect on your business, financial condition and results of operations.

In addition, the SEC staff has asked registrants to disclose any material litigation risks related to climate change and their potential impact.

#### **Example SEC staff comment: Litigation risks**

We note that you are a party to various routine legal proceedings, disputes and claims arising in the ordinary course of your business, including those that arise from environmental claims. Disclose any material litigation risks related to climate change and explain the potential impact to the company.

### **Indirect consequences of regulation or business trends**

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

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

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



**Example SEC staff comment: Indirect consequences of regulation or business trends**

To the extent material, discuss the indirect consequences of climate-related regulation or business trends, such as the following:

- ▶ Decreased demand for goods or services that produce significant greenhouse gas emissions or are related to carbon-based energy sources
- ▶ Increased demand for goods that result in lower emissions than competing products
- ▶ Increased competition to develop innovative new products that result in lower emissions
- ▶ Increased demand for generation and transmission of energy from alternative energy sources
- ▶ Any anticipated reputational risks resulting from operations or products that produce material greenhouse gas emissions
- ▶ Any new climate-related opportunities, such as carbon-negative products

**Physical effects of climate change**

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

**Example SEC staff comment: Physical effects of climate change**

Please describe to us the physical effects of climate change on your operations and results, such as weather-related damages to your property or operations, and weather-related impacts on the cost or availability of insurance. Include quantitative information with your response for each of the periods covered by your Form 10-K and explain whether increased amounts are expected in future periods. In addition, please tell us how you considered disclosing the potential for indirect weather-related impacts that have affected or may affect your major customers.

**Expenditures for climate-related projects and increases in compliance costs**

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

**Example SEC staff comment: Expenditures for climate-related projects**

It appears you have identified climate-related projects in your sustainability report, such as projects related to a transition to zero emissions. Tell us how you considered providing disclosure regarding past and future capital expenditures for climate-related projects. Include quantitative information for the periods covered by your Form 10-K and for future periods as part of your response.

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

**Example SEC staff comment: Increases in compliance costs**

Please tell us about and quantify compliance costs related to climate change for each of the periods for which financial statements are presented in your Form 10-K and whether increased amounts are expected to be incurred in future periods.

**Information provided in registrants' CSR reports**

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

**Example SEC staff comment: Information provided in registrants' CSR reports**

We note that you provided more expansive disclosure in your sustainability report than you provided in your SEC filings. Please tell us what consideration you gave to providing the same type of climate-related disclosure in your SEC filings as you provided in your sustainability report.

**Multiple rounds of letters**

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

**Example SEC staff comment: Multiple rounds of comment letters regarding climate-related disclosures*****Round 1 comment:***

To the extent material, discuss the indirect consequences of climate-related regulation or business trends, such as the following:

- ▶ Decreased demand for goods or services that produce significant greenhouse gas emission or are related to carbon-based energy sources
- ▶ Increased demand for goods that result in lower emissions than competing products
- ▶ Increased competition to develop innovative new products that result in lower emissions
- ▶ Increased demand for generation and transmission of energy from alternative energy sources
- ▶ Any anticipated reputational risk resulting from operations or products that produce material greenhouse gas emissions
- ▶ Potential climate-related opportunities, such as the development of semiconductors for use in technologies with lower energy consumption and greenhouse gas emissions

**Round 2 comment:**

Your response to prior comment five appears to be conclusory in nature without providing sufficient detail regarding the indirect consequences of climate-related regulation or business trends, including the specific items noted in our comment, and your assessment thereof. Please more fully describe the indirect consequences of climate change and tell us how you concluded they were not material. Provide support for your assessment, such as the quantitative analyses and qualitative factors referenced in your response

## Other areas of comment

In addition to the most frequent comment areas discussed above, the SEC staff has also issued comments on the following topics that could be applicable to a broad range of registrants:

- ▶ Risk factors
- ▶ Goodwill and intangible assets
- ▶ Business combinations
- ▶ Accounting error corrections, internal control over financial reporting, and disclosure controls and procedures
- ▶ Statement of cash flows

### Risk factors

The SEC staff continues to issue comment letters to registrants regarding the sufficiency of their risk disclosures in light of current macroeconomic and geopolitical factors, including the impact of inflation, interest rates, supply chain issues and labor shortages. The SEC staff has challenged registrants' risk factor disclosures as being too general (e.g., boilerplate disclosures) and asked registrants to more clearly describe how the macroeconomic factors may impact their operations, such as identifying and disclosing the types of inflationary pressures and how their business operations may have been materially impacted. In addition, the SEC has provided comments in cases where risk factor disclosures may need to be updated for evolving facts and circumstances.

In addition, consistent with the sample comment letter it issued regarding disclosures on **the direct and indirect effects of the war in Ukraine**, the SEC staff has asked registrants to disclose heightened cybersecurity risks, risks related to inflation and supply chain disruptions, and how the board of directors is overseeing these risks. The SEC staff continues to focus on registrants that have operations or are based in China and has asked them to disclose the potential legal and operational risks related to having their corporate structure based in or having the majority of the company's operations in China, consistent with the sample letter it issued on **China-based companies**.

### Goodwill and intangible assets

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

- ▶ Information about the registrant's goodwill and intangible assets impairment testing, including:
  - ▶ Disclosure of the methodologies, estimates and underlying assumptions used in the registrant's impairment analyses for both goodwill and intangible assets
  - ▶ Disclosures about reporting units that may be at risk of goodwill impairment

- ▶ Details about the timing of impairment charges
- ▶ Information about assessing goodwill and other intangible assets for impairment that should be included in the critical accounting estimates section of MD&A
- ▶ An explanation of how the intangible assets' useful lives were determined

#### ***Goodwill impairment analysis***

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

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

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

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

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

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

The SEC staff has frequently asked registrants to provide additional disclosure when the future impairment of goodwill represents a known uncertainty required to be disclosed in MD&A. The SEC staff often makes this request when potential indicators of impairment are observed.

To assist registrants in meeting this disclosure obligation, the SEC staff refers to the list of disclosures in Financial Reporting Manual (FRM) Section 9510.3 that registrants should provide when any reporting unit's estimated fair value does not substantially exceed its carrying value (i.e., the reporting unit is at risk of failing a future impairment test under ASC 350).

**Example SEC staff comment: Goodwill impairment analysis**

Please disclose whether you believe the estimated fair values of your reporting units substantially exceed their carrying values. For any reporting units that have estimated fair values that do not substantially exceed their carrying values, please provide useful and meaningful information that would allow investors to better assess the probability of a future goodwill impairment, including the following:

- ▶ Identify the reporting unit and quantify the amount of goodwill allocated to the reporting unit.
- ▶ Disclose the percentage by which the estimated fair value exceeded carrying value as of the date of the most recent impairment test.
- ▶ Disclose and discuss the specific critical assumptions used in your fair value determination.
- ▶ Address the degree of uncertainty associated with your key assumptions and disclose how changes in key assumptions could impact your fair value determination.
- ▶ Describe potential events and/or changes in circumstances that could reasonably be expected to negatively affect your key assumptions.

Please refer to Item 303(b)(3) of Regulation S-K.

The SEC staff has requested enhanced disclosure for reporting units that have estimated fair values that do not substantially exceed their carrying values.

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

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

***Other intangible asset impairment analysis***

Under ASC 350, *Intangibles – Goodwill and Other*, an indefinite-lived intangible asset should be tested for impairment annually or more frequently if events or changes in circumstances indicate that it is more likely than not that the asset is impaired. Under ASC 360, *Property, Plant, and Equipment*, long-lived assets to be held and used (including finite-lived intangible assets) are tested for impairment when factors exist that indicate that the carrying amount of a long-lived asset or asset group may not be recoverable.

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

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

#### ***Useful life determination***

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

#### **Example SEC staff comment: Useful life determination – finite-lived intangible assets**

Please tell us and explain in the notes to your financial statements how you determined the useful lives that are being used to amortize customer relationships. As part of your response and your revised disclosure, please explain in further detail why you believe that these categories of intangibles will continue to contribute to your expected cash flows for a period of 25 years from the acquisition date pursuant to the guidance in ASC 350-30-35.

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

#### **Business combinations**

##### ***ASC 805, Business Combinations***

Registrants that engage in acquisition transactions must determine whether the transaction represents a business combination (i.e., the acquired activities and assets constitute a business) or an asset acquisition in accordance with ASC 805. This determination, which may require significant judgment, is critical because the accounting for a business combination differs significantly from that of an asset acquisition.

The SEC staff has asked registrants to support their conclusions that their acquisitions did or did not meet the definition of a business under the criteria in ASC 805-10-55-3A through 55-9.

#### **Example SEC staff comment: Application of ASC 805**

We note that your acquisition was accounted for as a purchase of assets. Tell us why this transaction did not constitute the acquisition of a business. Your response should clearly explain why the acquired entity did not represent a business in accordance with the guidance outlined in ASC 805-10-55-4 through 55-6 and ASC 805-10-55-8 through 55-9.

Additionally, ASC 805 requires registrants to provide various disclosures associated with business combinations, if they are material. These disclosures help users of financial statements evaluate the nature and financial effect of business combinations. The SEC staff has requested that registrants expand their disclosures about business combinations to provide the information required by ASC 805. For example, the staff has asked registrants to include the pro forma information required by ASC 805-10-50-2(h) and expand their disclosures to include additional information about each acquisition (e.g., acquisition date, amount and form of consideration, percentage acquired, acquisition-related costs).

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 the disclosures were not provided. It is important to note that the evaluation of materiality for purposes of complying with the pro forma disclosure requirements in ASC 805 is separate and distinct from the significance test performed for the purposes of presenting pro forma financial information in accordance with Article 11 of Regulation S-X.

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

#### ***Application of Rule 3-05, Rule 3-14, and Article 11 of Regulation S-X***

A registrant that determines it has acquired a business (based on the SEC's definition in Rule 11-01(d)) is required to provide financial statements in accordance with Rule 3-05 (for acquired businesses) or Rule 3-14 (for acquired real estate operations) and pro forma financial information in accordance with Article 11 if the business is significant to the registrant. Significance is measured using the asset test, the investment test and the income test described in Rule 1-02(w).

Over the past year, the SEC staff has sought more details about how registrants concluded that separate financial statements and pro forma financial information were not required under Rule 3-05 or Rule 3-14 and Article 11, respectively. The SEC staff may also review publicly available information, other than SEC filings, to identify any acquisitions completed by the registrant. When the SEC staff has identified an acquisition that the registrant completed, and the registrant did not file separate financial statements or pro forma information for that business, it has often requested that the registrant provide the relevant significance test calculations and an explanation of its analysis of the requirements of Rule 3-05 or Rule 3-14 and Article 11.

Registrants should maintain contemporaneous documentation of significance tests performed and their analysis of Rule 3-05 or Rule 3-14 and Article 11 requirements, particularly when they conclude that an acquisition is not significant.

#### **Example SEC staff comment: Application of Rule 3-05 and Article 11 of Regulation S-X**

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

#### **Statement of cash flows**

The SEC staff has issued comments on the classification of cash flows as operating, investing and financing activities in the statement of cash flows. The SEC staff often comments when classification of cash flow activities is not clear, appears incorrect or is inconsistent. Further, when a registrant discloses that certain cash flow activities have been reclassified, the SEC staff may ask registrants to provide additional information as to the nature of the reclassification and the facts and circumstances leading to it.

#### **Example SEC staff comment: Statement of cash flows**

Clarify for us the nature of the cash flow activity that allowed you to reclassify the changes in reserve liabilities from cash flows from operating activities to cash flows from financing activities. In light of the presentation changes and reclassifications, tell us how you considered whether this was the correction of an error under the accounting and disclosure guidance in ASC 250, *Accounting Changes and Error Corrections*.

## Accounting error corrections, internal control over financial reporting, and disclosure controls and procedures

The SEC staff has requested additional information about a registrant's materiality assessment when it discloses the correction of an immaterial error in previously issued financial statements (e.g., "little r" restatements). For example, the SEC staff has questioned whether all qualitative and quantitative factors have been considered when a registrant concluded the error is not material to previously issued financial statements, pursuant to the guidance in Staff Accounting Bulletin (SAB) 99, *Materiality*, and ASC 250.

### Example SEC staff comment: Error correction materiality assessment

We note from your disclosure that you recorded an additional \$XX million of income tax expense and a corresponding increase to deferred tax liabilities in 2022 to correct identified errors related to your 2021 tax provision. Please provide a detailed quantitative and qualitative analysis that supports your conclusion that the identified errors are not material to the periods presented.

The SEC staff has challenged the effectiveness of internal control over financial reporting (ICFR) and disclosure controls and procedures (DCPs) when a registrant corrects a prior-period error, including corrections of immaterial out-of-period errors during the current period. The SEC staff may request additional information such as:

- ▶ A detailed description of the error, including who identified the error, when and how it was identified, and whether it was the result of a control deficiency
- ▶ A description of any control deficiency identified, including the registrant's evaluation of the severity of the deficiency and any remediation plans or the rationale for the registrant's conclusion that there was not a material weakness

The SEC staff reminds registrants that management's assessment must consider the magnitude of the potential misstatement that could result from a control deficiency, and the actual error is only the starting point for determining the potential impact and severity of a deficiency. The SEC staff has also questioned management's judgment when it attributes a material error to a control deficiency but does not conclude that the deficiency is a material weakness.

Further, when there are indicators of control deficiencies in filings that don't relate to accounting errors (e.g., the omission of required certifications or exhibits), the SEC staff has asked registrants to explain whether those deficiencies were identified by management and, if so, describe their severity, including whether DCPs are ineffective.

The SEC staff has also challenged registrants that say they concluded that ICFR was ineffective (e.g., when a material weakness was identified) but DCPs were effective.

### How we see it

We expect the SEC staff to continue asking questions about management's materiality assessment of accounting errors and challenging management's conclusions about the effectiveness of ICFR and DCPs.

## Looking ahead

We expect the SEC staff to continue to focus on the topics discussed above in the upcoming year. The SEC staff may also expand its comments related to eXtensible Business Reporting Language (XBRL) disclosures, pay versus performance disclosures, cybersecurity-related disclosures, and other disclosures made in response to recently issued or amended SEC rules and financial accounting standards.



## Pay versus performance disclosures

The SEC staff may focus on registrants' pay versus performance disclosures, which were first included in proxy and information statements in 2023.

The staff may comment on disclosures that do not sufficiently or clearly describe the relationship between executive compensation and the registrant's performance as required by Regulation S-K Item 402(v)(5). The SEC staff has noted that it is not sufficient to say that no relationship exists, even if a particular measure is not used in determining executive compensation. The staff may also request that registrants revise their future filings when disclosures do not meet the requirements of Regulation S-K Item 402(v), including when:

- ▶ Tabular disclosures exclude any of the required columns
- ▶ Footnotes to tabular disclosures do not describe valuation assumptions used to calculate executive compensation actually paid that materially differ from those disclosed on the grant date of equity awards
- ▶ A non-GAAP measure is presented as a company-selected measure in the tabular disclosure but the disclosure does not describe how the measure is calculated from the registrant's audited financial statements

## Cybersecurity-related disclosures

We expect the cybersecurity risk management, strategy and governance disclosures required under the **new rules** to receive attention from the SEC staff in the coming year. We have previously seen the SEC staff ask a registrant to disclose the nature of the board of directors' role in overseeing its cybersecurity risk management, how the board administers the oversight function and how it impacts the board's leadership structure under Regulation S-K Item 407(h).

## Disclosures related to recently finalized rulemaking or standard-setting

The SEC staff may review and issue comments on new or revised disclosures made in response to recently finalized or amended SEC rules, including disclosures about Exchange Act Rule 10b5-1 insider trading plans, share repurchases and recovery of erroneously awarded compensation.

The staff may also comment on disclosures resulting from the amendments to ASC 280 once they are finalized and implemented by registrants.

## XBRL disclosures

The SEC staff recently published a **sample comment letter** to illustrate the types of comments it may issue to registrants on XBRL and Inline XBRL disclosures and may expand the comments it issues on these disclosures. The SEC staff said it may issue comments other than those in the sample comment letter depending on the type of filing under review and the facts and circumstances.

## Endnotes:

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

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## Appendix: Resources

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

### MD&A

- ▶ [2022 SEC annual reports – Form 10-K](#)
- ▶ [2022 AICPA & CIMA Conference on Current SEC and PCAOB Developments](#)
- ▶ To the Point, [SEC issues guidance on disclosures about key performance indicators and other metrics in MD&A](#)

### Non-GAAP measures

- ▶ Technical Line, [Navigating the requirements for non-GAAP financial measures](#)
- ▶ [2022 SEC annual reports – Form 10-K](#)

### Segment reporting

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

### Revenue recognition

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

### Climate-related disclosures

- ▶ Technical Line, [Revisiting the SEC's guidance on climate change disclosures in today's environment](#)
- ▶ To the Point, [SEC proposes enhancing and standardizing climate-related disclosures](#)

### Risk factors

- ▶ [2022 SEC annual reports – Form 10-K](#)

### Goodwill and intangible assets

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

### Business combinations

- ▶ Financial reporting developments, [Business combinations](#)
- ▶ Technical Line, [Applying the SEC's requirements for significant acquired businesses](#)
- ▶ Technical Line, [How to apply the amended S-X Rule 3-14 to real estate acquisitions](#)

### Accounting error corrections, internal control over financial reporting, and disclosure controls and procedures

- ▶ [2022 SEC annual reports – Form 10-K](#)
- ▶ Financial reporting developments, [Accounting changes and error corrections](#)

### Statement of cash flows

- ▶ Financial reporting developments, [Statement of cash flows](#)

### Looking ahead

- ▶ Technical Line, *How to apply the SEC's new pay versus performance disclosure requirements*
- ▶ Technical Line, *A closer look at the SEC's new rules on cybersecurity disclosures*
- ▶ To the Point, *SEC adopts rules to require 'clawback' policies and disclosures*