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SEC COMMENT LETTER TRENDS – A PROACTIVE APPROACH

Overview

In accordance with the Sarbanes-Oxley Act of 2002, the Division of Corporate Finance (DCF) of the Securities and Exchange Commission (SEC) is required to review each SEC registrant at least once every three years. The DCF uses judgment in determining the frequency and rigor of this review, the latter of which may include a complete cover-to-cover review, a financial statement review, or a targeted review based on a particular industry issue or a new accounting standard. When issuing comments to a company, the DCF may request that a company provide additional information so the staff can better understand the company's disclosures, revise disclosures in a document that has been filed with the SEC, or provide additional or comparatively different disclosure(s) in a future filing with the SEC. This may result in an iterative review process with multiple rounds of comments from the SEC staff and responses from the filer until the issues, identified in the review, have been fully resolved.

Background

While the total number of comment letters issued annually by the SEC has been trending downward in recent years (approximately 4,500 comment letters in 2014 versus approximately 2,000 issued in 2018), the SEC has clearly maintained a focus on several key topics as indicated in the table below. These items represent areas ranking the highest for most comment letters in each year.

	Ranking for the twelve month period ended July 31,				
Topic	**2018**	**2017**	**2016**	**2015**	**2014**
Non-GAAP measures	1	1	1	4	6
Management's discussion and analysis	2	2	2	1	1
Fair value measurements	3	3	3	2	2
Revenue recognition	4	5	5	3	4
State sponsors of terrorism	5	8	16	16	16

Ranking data for years 2014-2018 provided by Audit Analytics.

Data is based on comments related to Form 10K and Form 10Q filings

During the 35-day government shutdown (December 21, 2018 - January 25, 2019), the SEC staff did not review corporate filings or issue any comment letters. During a comparable period in the period year, over 300 comments were issued representing nearly 20% of all comment letters issued. As a result, the 2019 comment letter process has been slowed significantly.

Non-GAAP Measures: There are several underlying issues related to disclosures around Non-GAAP measures that have been the focus of the SEC in recent years.

- Prominence of Non-GAAP items relative to GAAP financial measures

- Inclusion/(exclusion) of non-recurring items; consistency in application between periods

- Consistency of non-GAAP measures in other public information as compared to annual and/or quarterly filings

Companies should be particularly aware that the SEC staff will consider all information issued by a company when evaluating their disclosures. This is a common issue as companies may disclose information in earnings releases, investor presentations, or on company websites that is inconsistent with annual or quarterly filings. Companies should seek to be consistent in their discussions around non-GAAP items and ensure they do not receive greater prominence than GAAP financial measures in their disclosures.

Management's Discussion and Analysis (MD&A): The focus of comments concerning management's discussion and analysis has primarily involved three key topics, in approximate order of magnitude.

- **Results of Operations:** The SEC has indicated filers should be providing information to investors to enable them to understand how management views their operations. Disclosures should provide not only discussion around significant changes between periods but should also quantify the effects of each unique factor included in the discussion. Key metrics and other information should be disclosed to help enable the reader to evaluate the company in the same way as management.

- **Critical Accounting Policies and Estimates:** The focus of these comments commonly indicates that the discussion around policies and estimates is too general or even redundant as compared to the notes to the financial statements. The intention of this section of the MD&A is to not only describe the company's critical accounting policies and estimates, but to also provide insight into the significant judgments made by management in their application. In doing so, management should also seek to disclose significant uncertainties related to these judgments.

- **Liquidity and Capital Resources:** A common issue presented by the SEC staff, concerning the liquidity and capital resources discussion of the MD&A, is that companies will simply provide a narrative restatement of the cash flow statement. The SEC staff has indicated that the key drivers of cash flow should be clearly described. The disclosures should also include not only future cash requirements, but any trends of uncertainties in meeting those needs.

Fair Value Measurements: Comments in this area typically require registrants to provide greater detail concerning the various inputs and valuation techniques utilized by management or third parties in determining fair value, especially for level three instruments and non-recurring measurements. For example, these may include discount rates, premiums, cash flow forecasts, or other details concerning valuation models utilized.

Revenue Recognition: With the adoption of the new revenue standard (ASC 606 – Revenue From Contracts With Customers), there are several issues the SEC has been seeking to address in registrants' disclosures. Several of the most notable include the following.

- **Disaggregation of Revenue** – Adequate disclosures and consistency with other materials such as earnings releases
- **Performance Obligations** – In-depth discussion concerning the nature of a registrant's performance obligations and disclosure of remaining performance obligations
- **Cost of Obtaining Contracts** – Basis for conclusions concerning capitalization of certain costs and pattern of amortization
- **Variable Consideration** – Methods used by management in estimating variable revenue

State Sponsors of Terrorism: The U.S. Secretary of State has designated four countries as state sponsors of terrorism — the Democratic People's Republic of Korea (North Korea), Iran, Sudan, and Syria. Companies are required to disclose the nature of any activities in these countries, any revenues earned, and the nature of any ongoing contracts or relationships in these countries.

Other: Other notable areas of focus from the SEC in past years include income taxes, business combinations, segment reporting, signatures exhibits & agreements, and goodwill.

Insights

When considering the appropriateness of your company's disclosures, it is important to remember that a quality review of your SEC filings should be an ongoing process. It is not enough to simply rollover your company's disclosures each year. Companies should challenge themselves to constantly seek ways to improve their disclosures which, in turn, will help mitigate the risk of receiving comments letters from the SEC. This can be done by benchmarking your disclosures against peer companies within your industry utilizing tools such as Intelligize. Additionally, companies can consider comment letters that have been recently issued by the SEC to these same peers and determine whether or not proactive adjustments should be made to their disclosures to avoid receiving the same comment. With the implementation of significant new accounting standards such as revenue recognition and leases, it is more important than ever that that companies continue to evaluate their disclosures on an ongoing basis to ensure their compliance with disclosure requirements and evolving trends around those disclosures.

In a May 2018 interview concerning the new revenue recognition standard, Kyle Moffatt, the SEC's chief accountant for the DCF, told those gathered at Baruch College's financial reporting conference, "We aren't planning to beat up on companies in this first year." Nevertheless, we expect the SEC will continue to monitor these new disclosures carefully and encourage companies to continue to enhance their disclosures around these new standards. During a Financial Executives International conference, Moffatt reinforced this by stating, “As you prepare your 10K, revisit your disclosures each quarter, and reassess or update those disclosures. We do expect companies will continue to refine their revenue recognition disclosures.”

Additionally, management should consider industry-specific challenges and comment letter trends when evaluating their disclosures. Certain topics are far more relevant for particular industries and have a greater chance of becoming the focus of an SEC comment letter. Reach out to your auditors or other consultants for advice on these topics to ensure you are taking adequate measures to reduce your risk of receiving a difficult comment from the SEC.

If you do receive a comment letter from the SEC, consider the following:

- Companies are typically required to provide an initial response to the SEC within ten days. However, companies should not rush to a conclusion without taking due care in preparing their response. Both the comment letter from the SEC and a company’s response will eventually be made public documents. As such, it is normal for companies to request an extension from the SEC as necessary for particularly difficult comments.

- It is always easier to schedule a conference call with the SEC staff to discuss the issue. If a comment is unclear, a company should seek clarification from the SEC rather than responding without fully understanding the question, thus increasing the likelihood of a second round of comments.

- It is vital to assemble the appropriate team to prepare your response. You should include outside counsel, your auditors, and other consultants as appropriate to leverage their experience with these matters as some comments may relate to controversial or confidential topics. In the event your response will require the disclosure of confidential information, certain items can be redacted in the public response filed with the SEC.

- If, as a result of a comment letter, a revision is required to an existing filing or an addition needs to be made to a future filing, it is recommended to include the draft disclosure in your response to the SEC. This will further help avoid subsequent comments concerning the same topic.

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Final Thoughts

Ultimately, the accuracy and adequacy of disclosures are the responsibility of the company and its management team. It should be an ongoing effort to maintain and enhance disclosures to meet the various disclosure requirements of both new and existing standards. As indicated above, all registrants are reviewed at least once every three years to some degree. By considering these trends and taking a proactive approach with the quality of your SEC filings, you can avoid these common pitfalls.

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