SEC Comments and Trends

An analysis of current reporting issues

October 2012
Every year, we track the Securities and Exchange Commission (SEC) staff’s comments on public company filings to provide you with insights on the SEC staff’s concerns and areas of focus. Although each registrant’s facts and circumstances are different, the economic conditions in which they operate and their financial reporting challenges are often similar. Understanding the comments and trends discussed in this publication can help as you head into the year-end reporting season.

In its comments, the SEC staff questions disclosures that may conflict with SEC rules or accounting principles, as well as disclosures the SEC staff believes could be enhanced or clarified. The resolutions vary. In some cases, registrants sufficiently support their existing accounting or disclosures, and in others they agree to expand disclosures in future filings or amend previous filings. Appendix C of this publication provides an overview of the SEC staff filing review process, as well as best practices for responding to staff comments. While the SEC staff continues to comment on familiar topics such as significant estimates, revenue recognition, impairment and financial instruments, it has increased its focus in other areas, including:

- Nonperformance covenants contained in lease agreements and how these contractual provisions affect the classification of leases
- Pro forma financial information disclosed in registration statements and Form 8-Ks reporting a significant acquisition, including how the requirements of Article 11 of Regulation S-X have been met for various pro forma adjustments
- The presentation of guarantor condensed consolidating information pursuant to the relief provided in Rule 3-10 of Regulation S-X

Segment reporting continues to be a common area of focus in SEC comment letters. The SEC staff often considers disaggregated information to be better for users of financial statements. As a result, the staff frequently questions registrants’ conclusions about operating segments being economically similar and their aggregation into a reportable segment. The SEC staff also requests that registrants provide more robust analysis of their segments in their MD&A.

The number of SEC staff comments on loss contingency disclosure requirements has stabilized over the past year. While the SEC staff has said that it has seen improvement in the disclosure of loss contingencies, it is expected to continue to focus on evaluating and enforcing compliance with ASC 450 in its filing reviews.

The SEC staff continues to focus on disclosures for registrants with foreign operations. In particular, the SEC staff has been questioning the tax effects of operating in foreign jurisdictions, including the effects on liquidity of indefinitely reinvesting foreign earnings. The SEC staff also has been asking registrants to provide more detailed disclosures about any exposure they may have to European debt. To help companies determine what to disclose about their exposures to countries experiencing significant economic, fiscal or political challenges, the SEC staff issued CF Disclosure Guidance: Topic No. 4: European Sovereign Debt Exposures in January 2012. CF disclosure guidance is a new type of interpretive guidance that the SEC staff has been using to provide observations and views about disclosures required by existing SEC rules and regulations.
Future areas of SEC staff focus may include:

- Non-GAAP disclosures that modify pension-related expenses
- Emerging growth companies’ confidential submissions under the recently enacted Jumpstart Our Business Startups Act
- The new fair value disclosures in ASU 2011-04, primarily related to Level 3 measurements
- The new qualitative assessment for testing goodwill and indefinite-lived intangibles for impairment

The main section of this publication discusses matters that relate to all registrants. Appendices A and B highlight matters related to specific industries and foreign private issuers. In this year’s publication, we have included example SEC comments to illustrate the staff’s questions and to help clarify the trends we discuss.

We hope this publication helps you understand the comment process and issues that are of keen interest to the SEC staff. Ernst & Young professionals are prepared to discuss any concerns or questions you may have.
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Summary of issues noted
The SEC staff often requests further disclosure about critical accounting estimates that are subject to significant judgment. The SEC staff discussed the importance of critical accounting estimates disclosures in its Financial Reporting Series roundtable, held in November 2011. In particular, the SEC staff believes that MD&A should make investors aware of the quality and variability of management’s most significant judgments, including the assumptions and related methodologies underlying those estimates.

Analysis of current issues
Critical accounting estimates are those that are most important to the financial statement presentation and that require the most difficult, subjective and complex judgments. The SEC staff has noted that registrants’ disclosures about critical accounting estimates often are too general and, while they should be consistent with the key estimates discussed in the notes to the financial statements, they should provide a more robust analysis than what is in the notes. SEC Financial Release No. 72, Commission Guidance Regarding Management’s Discussion and Analysis of Financial Condition and Results of Operations (FR-72), reminds registrants that MD&A rules require disclosure of a critical accounting estimate in either of the following cases:

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

In these cases, the SEC expects registrants to provide analysis of the uncertainty in making the accounting estimate for the financial reporting period and the variability that is reasonably likely until the uncertainty is resolved. Specifically, the SEC indicates that the MD&A disclosure should (1) address why the accounting estimate or assumption bears the risk of change and (2) analyze the following if material:

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

In a Financial Reporting Series roundtable in November 2011, participants discussed uncertainty in financial statement measurements and disclosures and the importance of critical accounting estimates disclosures in understanding the related effects on financial reporting. Participants noted that measurement bases should reflect how and when assets or liabilities will affect future cash flows, and the disclosures in critical accounting estimates should be clearly linked to the financial statements. These disclosures should supplement the summary of significant accounting policies in the notes to the financial statements by focusing on areas that are subject to significant judgment, and by providing meaningful analysis of the assumptions and
methods used by management. While accounting policies in the notes to the financial statements generally describe the method used to apply an accounting principle, the discussion in MD&A should provide readers with more insight into management’s judgments about the uncertainties involved in applying a principle at a given time and the variability that is reasonably likely to result from its application.

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

**Example from SEC comment letter: Critical accounting estimates**

We note certain assumptions and estimates are identified throughout your discussion of critical accounting policies. The critical accounting policies discussion should describe how these estimates and related assumptions were derived, how accurate those estimates/assumptions have been in the past, and whether the estimates/assumptions are reasonably likely to change in the future. You should provide quantitative as well as qualitative information when information is reasonably available. Tell us what consideration you gave to providing these disclosures for each of the accounting policies described.

The SEC staff frequently requests enhancements to the MD&A discussion of particular critical accounting estimates, which we discuss separately in this publication (e.g., loss contingencies, goodwill impairment assumptions, allowance for doubtful accounts).

**Resources**

2011 SEC annual reports – Form 10-K (SCORE No. CC0337), Ernst & Young, November 2011.
Liquidity and capital resources

Summary of issues noted
The SEC staff frequently questions disclosures in the liquidity and capital resources section of MD&A, focusing on:

- Sources and uses of cash and the availability of cash to fund liquidity needs
- Implications of liquid assets held by foreign subsidiaries when there is an assertion for tax purposes that earnings of those foreign subsidiaries have been indefinitely reinvested
- Transparency in the contractual obligations table and its footnotes for interest payments and other items

Further, as the uncertain economic environment and weak operating results in certain sectors present operating and financing challenges for many registrants, affecting their ability to comply with financial covenants, the SEC staff often requests more comprehensive disclosures about material debt covenants. In these requests, the SEC staff asks for expanded disclosure when there is an elevated risk of default or when management has concluded it is reasonably likely that covenants will not be met in the future.

Analysis of current issues
General disclosures
Items 303(a)(1) and (2) of Regulation S-K require that a registrant discuss known trends, demands, commitments, events or uncertainties that are reasonably likely to materially affect liquidity or capital resources. The SEC staff requests that registrants expand disclosures to comply with these requirements. Specifically, the SEC staff has requested that registrants disclose the following:

- A discussion of whether identified trends will continue and for how long, as well as steps the registrant is taking to address the trends, including plans to remedy any identified material deficiency in short- or long-term liquidity
- An analysis of all internal and external sources of liquidity, beyond cash on hand, as of the balance sheet date
- Amounts outstanding and available at the balance sheet date under each source of liquidity, with these disclosures highlighting cash needs over the next 12 months, including any significant planned capital expenditures
- Whether these capital expenditures are necessary or discretionary
- A discussion of the sufficiency of the amount available under an existing short-term credit arrangement, the anticipated circumstances requiring its use, any uncertainty surrounding the ability to access funds when needed and any implications of not being able to access the funds
- A discussion of any uncertainty or trends involving compliance with financial covenants and the material implications of a breach
The registrant’s calculated ratio for the latest compliance dates or periods, when the filing specifies minimum financial ratios that the registrant is reasonably likely to fail to achieve

A discussion and analysis of cash flows that addresses material changes in the underlying drivers of cash flows for all periods presented in the financial statements, rather than a recitation of items that are readily apparent from the statement of cash flows

In September 2010, the SEC issued Financial Release No. 83, Commission Guidance on Presentation of Liquidity and Capital Resources Disclosures in Management’s Discussion and Analysis (FR-83). FR-83 notes that MD&A should consider whether obligations to repurchase assets are reasonably likely to result in the use of a material amount of cash or other liquid assets and whether cash management and risk management policies are relevant to an assessment of financial condition.

FR-83 also specifies that a registrant disclosing a capital or leverage ratio in its filings should disclose why the financial measure is useful to understanding its financial condition and consider the following:

- Any ratio or measure included in an SEC filing should be accompanied by a clear explanation of how it was calculated
- If the financial measure differs from other measures commonly used in the registrant’s industry, a discussion of those differences or a presentation of those other measures might be necessary to avoid a misleading disclosure

Since the release of FR-83, the SEC staff has requested that registrants enhance disclosures about significant liquidity ratios and explain any significant fluctuations in the ratios.

**Foreign earnings**

The SEC staff continues to request that registrants consider the effect on consolidated liquidity when they assert their intention to indefinitely reinvest foreign earnings under ASC 740. The SEC staff requests disclosure of the amount of cash and short-term investments held by foreign subsidiaries that are not available to fund domestic operations unless the funds are repatriated and the potential income tax payments that would be required upon repatriation.

In response to these requests, registrants have provided MD&A disclosure such as, “As of December 31, 2011, $2 billion of the $2.5 billion of cash and short-term investments (on the consolidated balance sheet) was held by foreign subsidiaries.” Following this type of disclosure, the registrant then may be asked to discuss the income tax implications of repatriation and the effects of repatriation on liquidity.

This can be an important disclosure for investors to understand the liquidity of the registrant. While a registrant may appear to have significant liquid assets, a large portion of those assets may not be generally available for use domestically without material tax implications.
Example from SEC comment letter: Foreign earnings

If significant to an understanding of your liquidity, in future filings please clarify the amount of cash and investments held outside of the US. Additionally, to the extent material, please describe any significant amounts that may not be available for general corporate use related to cash and investments held by foreign subsidiaries where you consider earnings to be indefinitely invested. Also, address the potential tax implications of repatriation.

Contractual obligations

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

FR-83 notes that the goal of the contractual obligations table is to present a meaningful snapshot of cash requirements arising from contractual payment obligations. The MD&A rules permit flexibility so that the presentation can reflect company-specific information in a way that is suitable to a registrant’s business. FR-83 encourages registrants to develop a presentation that is clear and understandable and that appropriately reflects the categories of obligations that are meaningful in light of their capital structure and business.

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

Recently, the SEC staff has questioned the completeness of items included in registrants’ contractual obligations tables and asked those companies to provide reasons for excluding certain items from the table and considerations for compliance with Item 303(a)(5) of Regulation S-K. For example, the SEC staff has asked companies to include amounts for future interest payments in the contractual obligations table or a footnote to the table. When interest rates are variable, registrants should describe the assumptions that were used to estimate future payments.

Example from SEC comment letter: Contractual obligations

In future filings, please revise your table of contractual obligations to include interest payments on your long-term debt/notes payable to increase transparency of cash flows. When estimating variable interest payments, you may use your judgment to determine whether or not to include estimates of future variable rate interest payments in the table or in a footnote to the table. Regardless of whether you decide to include variable rate estimated interest payments in the table or in a footnote, you should provide appropriate disclosure with respect to your assumptions.
Debt covenant compliance

With a significant amount of US corporate debt maturing within the next several years, many non-investment-grade companies may face difficulty refinancing current debt and complying with covenant requirements. Consequently, the SEC staff may continue to request more comprehensive disclosures of liquidity and covenant compliance in MD&A, as well as the notes to the financial statements when required.

Failing to comply with material debt covenants can have a significant effect on a registrant’s liquidity. Registrants whose risk of noncompliance with debt covenants is more than remote may be asked to expand their disclosures. The SEC staff focuses on providing greater transparency into the nature of such covenants, as well as the potential risks and effects of noncompliance on the registrant’s financial condition and liquidity. Specifically, the SEC staff requests the following types of disclosures:

- Actual quantitative ratios or amounts compared with required minimum/maximum values contained in debt covenants, along with explanations of how such ratios or amounts are determined and their relationship to amounts reported under US GAAP
- Default provisions in debt agreements that would either accelerate the repayment of debt, if not cured within applicable grace periods, or trigger cross-default provisions in other debt agreements
- Risk factors associated with technical defaults or breach of financial ratio covenants in credit facilities
- The nature of financial ratio violations and their effect on the registrant’s liquidity, if material
- The nature of waivers or modifications of existing debt covenants to cure or prevent potential violation(s), including how long any waivers apply and a description of the related covenant
- Disclosure of the likelihood of failing financial covenants in the future
- Specific terms of material debt covenants and performance relative to the covenants
- Covenant restrictions on the ability to pay dividends and the source of such restrictions

In connection with inquiries about the nature of a covenant violation or a lender’s waiver of debt covenants, the SEC staff also questions registrants’ classification of debt in the balance sheet as either current or noncurrent. The classification conclusion requires consideration of the maturity date of the debt, rights of the lender to accelerate repayment, debt covenants and waivers for failed covenants. The accounting literature addressing the classification of debt is found in ASC 470-10-45, with some examples and interpretive guidance in ASC 470-10-55.

Resources

2011 SEC annual reports – Form 10-K (SCORE No. CC0337), Ernst & Young, November 2011.

Hot Topic – SEC issues MD&A guidance: Liquidity and capital resources (SCORE No. CC0304), Ernst & Young, 22 September 2010.
Non-GAAP financial measures

**Summary of issues noted**

The SEC staff frequently requests that registrants modify or provide additional disclosure when presenting non-GAAP financial measures. Recent comments on non-GAAP financial measures have focused on the following:

- Presentations that give greater prominence to non-GAAP financial measures than GAAP measures, including disclosures of full non-GAAP income statements
- Compliance with the disclosures about non-GAAP financial measures required by Item 10(e) of Regulation S-K, most notably appropriate disclosure about the usefulness of the non-GAAP financial measure to investors

Prior to his July 2012 departure, then SEC Chief Accountant James Kroeker publicly voiced concerns about the lack of transparency in disclosures about certain non-GAAP measures related to pension plan assets and obligations.

**Analysis of current issues**

After issuing non-GAAP Compliance and Disclosure Interpretations in January 2010 that made it easier for registrants to include non-GAAP financial measures in their filings, the SEC staff has focused more on compliance with presentation and disclosure requirements rather than on whether the non-GAAP financial measure is appropriate.

Item 10(e)(1)(i)(A) of Regulation S-K requires a presentation, with equal or greater prominence, of the most directly comparable financial measure or measures calculated and presented in accordance with GAAP. The SEC staff is particularly alert for situations in which registrants give undue prominence to non-GAAP information either in an SEC filing or a press release.

The prohibition on presenting non-GAAP financial measures with greater prominence than GAAP measures encompasses both the order of presentation and the degree of emphasis. For example, the SEC staff regularly challenges a discussion of non-GAAP financial measures that precedes the discussion of the corresponding GAAP measures or a discussion of non-GAAP measures that significantly exceeds the length of the discussion of the corresponding GAAP measures. In addition, non-GAAP financial measures must be presented with quantitative reconciliations to the most directly comparable GAAP measures. Specifically, the SEC staff has objected to registrants presenting anything resembling a full non-GAAP income statement as a form of reconciliation and has requested amendments in certain cases.

**Example from SEC comment letter: Non-GAAP financial measures**

We see that you present non-GAAP financial information and the related reconciliation required by Regulation S-K Item 10(e) in the form of an “adjusted” income statement. Please tell us how your presentation considers the guidance set forth in Compliance and Disclosure Interpretation 102.10. Under the cited guidance, it is generally not appropriate to present a non-GAAP income statement for purposes of reconciling non-GAAP measures to the most directly comparable GAAP measures.
The SEC staff also comments on the disclosures required by Item 10(e) of Regulation S-K about how a particular measure is useful to investors. In the SEC staff’s view, these disclosures tend to be boilerplate or too general to help readers understand how they should use a particular measure. If a registrant cannot explain how a particular measure is useful to investors or if the SEC staff believes the presentation is misleading, the SEC staff will ask for the non-GAAP measure to be removed.

When disclosing non-GAAP financial measures, registrants also should consider the following items that the SEC staff commonly notes in its comment letters:

› The presentation of a non-GAAP financial measure should clearly describe the nature of any adjustments to a standard measure and should not imply it is an unadjusted measure. For example, a measure that includes adjustments to the standard definition of EBITDA should not be labeled “EBITDA.”

› Adjustments to non-GAAP measures that are labeled as nonrecurring should only comprise items that are infrequent or unusual in nature, as required by item 10(e)(1)(ii)(B) of Regulation S-K. If the adjusted item has occurred within the past two years or is likely to recur within two years, then it should not be considered nonrecurring.

› The nature of certain adjustments to non-GAAP measures that are identified as nonrecurring are commonly questioned by SEC staff if the items appear to smooth the effect of certain transactions.

› Non-GAAP financial measures may be presented net of tax, if appropriate. If a registrant presents a non-GAAP measure net of tax, it should disclose how it calculated the tax effects when reconciling the non-GAAP financial measure to the most directly comparable GAAP measure.

› The tax effects of a particular item should be transparent. The SEC staff may question measures calculated using inconsistent tax treatments. For example, registrants often inappropriately present net income before stock compensation expense without also reflecting the tax effect of such compensation.

› If a registrant has a GAAP net loss but discloses non-GAAP net income, any presentation of non-GAAP diluted earnings per share should give effect to any dilutive potential common shares outstanding, even if they were anti-dilutive to the computation of diluted GAAP loss per share.

Before his recent departure, the Chief Accountant of the SEC publicly voiced concerns about adjustments to non-GAAP measures to eliminate recognized actuarial gains or losses that resulted from recent changes in certain registrants’ accounting policies for pension plans. This topic is discussed separately in the Pension and other postretirement benefit plans section of this publication.

Resources

2011 SEC annual reports – Form 10-K (SCORE No. CC0337), Ernst & Young, November 2011.

Hot Topic – SEC staff issues revised guidance on non-GAAP financial measures (SCORE No. CC0290), Ernst & Young, 13 January 2010.
**Results of operations**

*Summary of issues noted*

The SEC staff often requests that registrants explain the results of their operations with greater specificity, including identifying each material factor that has affected their earnings and that is reasonably likely to have a material effect on future earnings.

*Analysis of current issues*

Item 303(a)(3) of Regulation S-K provides general instructions for preparing MD&A disclosures about the results of operations. The SEC staff often asks registrants to include a more detailed discussion as required by Item 303(a)(3), including requesting that registrants:

- Describe any unusual or infrequent events or transactions, or any significant economic changes, that materially affect income from continuing operations and the extent to which income was affected (e.g., significant events that affect the registrant that have been disclosed in the press but not disclosed in an SEC filing)
- Describe any other significant components of revenue or expense necessary to understand the results of operations (such as components of cost of sales)
- Describe any known trends, events or uncertainties that have had or are expected to have a material effect on sales, revenue or income from continuing operations (such as the effect of uncertainties created by the debt crisis in Europe)
- Discuss how much of any material increase in net sales or revenue is due to business combinations, increased sales volume, introduction of new products or services, or increased sales prices
- Quantify, if possible, each factor's effect on net sales
- In addition to discussing the registrant as a whole, discuss segment information needed to understand the registrant's results of operations, including the effect the performance of a particular product line may have had on those results

FR-72 provides, among other things, additional interpretive guidance regarding the focus and content of results of operations disclosures. The SEC staff asks registrants to provide a more meaningful and detailed explanation of material period-to-period changes.

The SEC staff typically requests that registrants provide more granular quantification and discussion about the specific factors and the underlying business or economic reasons that contributed to material period-to-period changes. For example, when a registrant discloses that two or more qualitative factors have contributed to a material period-to-period change in a financial statement line item, the SEC staff often requests that each factor be quantified and analyzed to provide more meaningful disclosure.

The SEC staff also requests that registrants disclose whether the reasons contributing to material changes represent trends that are expected to have material future effects and how long those trends are expected to have an effect.
To allow investors to view the registrant through the eyes of management, FR-72 also suggests that registrants identify key performance indicators, whether financial or nonfinancial, that management uses to manage the business. The SEC staff frequently asks for additional disclosures about a registrant’s key performance indicators, especially when its review of information outside the registrant’s SEC filings indicates key performance indicators have not been disclosed within the filing.

Registrants should clearly identify which performance indicators management considers to be key and describe how those performance indicators are determined or defined by the company (e.g., same-store sales). They also should describe the underlying drivers of each key performance indicator identified and the significant effects those drivers could have on the results of operations.

**Foreign operations**

The SEC staff also looks for disclosures about liquidity, risk factors and results of operations for registrants with foreign operations, particularly in countries subject to political or financial risk or other uncertainties. The SEC staff looks for transparency in registrants’ disclosures when their foreign operations have a disproportionate effect on the financial statements relative to their size (e.g., registrants with relatively small operations in a foreign jurisdiction, but those operations have a significant impact on the consolidated financial statements). In those instances, the SEC staff has requested that registrants provide disaggregated financial information related to income statement or cash flow effects from a particular country.

Registrants should consider providing forward-looking information about any material trends and uncertainties or expected changes in business practices that may affect operations and liquidity, including whether the relationship between costs and revenues could be materially affected.

**Resources**

*2011 SEC annual reports — Form 10-K (SCORE No. CC0337), Ernst & Young, November 2011.*
SEC reporting issues

Board structure and nominee criteria

**Summary of issues noted**
The SEC staff has focused on disclosures about how a registrant considered diversity and other qualifications in board nominations and why the board’s leadership structure is most appropriate.

**Analysis of current issues**
As required by Item 407(c) of Regulation S-K, the SEC staff requests that a registrant disclose whether its nominating committee or board considers diversity in identifying director nominees and, if so, how. Also, with respect to each director, the SEC staff may request that the registrant specifically discuss what aspects of the individual’s experience led the board to conclude that the person should serve as a director for the registrant, as well as any other relevant qualifications, attributes or skills that were considered by the board.

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<td>Clarify whether the Governance and Nominating Committee considers diversity in selecting board candidates and whether it has a formal policy in considering diversity. See Item 407(c)(vi) of Regulation S-K.</td>
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Item 407(h) of Regulation S-K requires board leadership structure disclosures, including whether the same person serves as both the principal executive officer and chairman of the board, and why a registrant has determined that its leadership structure is appropriate, given its specific characteristics and circumstances.

The SEC staff frequently observes that registrants do not comply with the Item 407 disclosure requirements. For example, if a registrant discloses that it has an independent chairman of the board and a separate principal executive officer, the SEC staff requests a disclosure of why that leadership structure is the most appropriate for the registrant.

**Resources**
- 2012 proxy statements — An overview of the requirements (SCORE No. CC0339), Ernst & Young, November 2011.
- Hot Topic — SEC final rule: Proxy disclosure enhancements (SCORE No. CC0289), Ernst & Young, 18 December 2009.
Emerging growth companies

Summary of issues noted
Since enactment of the Jumpstart Our Business Startups Act (JOBS Act or Act) in April 2012, emerging growth companies (EGCs) have been taking advantage of the confidential submission process and scaled disclosures in their initial registration statements. Although the review process for this new category of issuer is just beginning, the SEC staff has reminded EGCs about the following disclosures and filing requirements:

- Discussion of EGC status and elections made under the EGC provisions of the JOBS Act
- Confidential submissions to the SEC staff must be substantially complete
- All confidential submissions, amendments and comment letter correspondence will ultimately be filed on EDGAR

Analysis of current issues
The JOBS Act was enacted on 5 April 2012. Title I of the JOBS Act created a new category of issuer called an EGC to encourage initial public offerings. The JOBS Act provides EGCs certain temporary exemptions and relief from certain filing requirements. The EGC provisions of the JOBS Act did not require rulemaking by the SEC to be effective. However, the SEC staff has issued answers to a series of frequently asked questions (FAQs) about the EGC provisions. They include the SEC staff’s expectations about EGC-related disclosures in initial registration statements. In its initial comments to EGCs, the SEC staff has been asking EGCs to revise their registration statement submissions to provide disclosures for a number of items that were outlined in the FAQs, including:

- Designation of the company as an EGC on the prospectus cover page
- Description of how and when a company may lose its EGC status
- Description of the exemptions available to EGCs (such as external audit requirement in Section 404(b) of the Sarbanes-Oxley Act of 2002 and executive compensation disclosures in Section 14A(a) and (b) of the Securities Exchange Act of 1934)
- Election to opt out of any extended transition period to comply with new or revised accounting standards as if the EGC were a privately-held company (i.e., follow public company effective dates) and that the election to opt out is irrevocable
- Otherwise, the implications of using the extended transition period to comply with new or revised accounting standards, including (1) a risk factor explaining that the delay in following public company effective dates could cause non-comparability of EGC financial statements to other public companies and (2) a discussion about this election in its MD&A section on critical accounting estimates
The JOBS Act allows EGCs to confidentially submit their initial registration statements, and to receive and respond to SEC staff comment letters on a confidential basis. EGCs should ensure that confidential submissions are substantially complete before sending them to the SEC staff for review. The SEC staff has indicated that some of the submissions it receives are not substantially complete (e.g., omission of a signed audit report or the required financial statements and exhibits). In these instances, the SEC staff notifies the EGC immediately and will generally not commence its review of the registration statement.

The SEC staff also reminds EGCs in its comment letters that they must publicly file the initial public offering (IPO) registration statement on EDGAR no later than 21 days before the company’s road show.

All amendments and correspondence with the SEC staff (such as EGC responses to SEC staff comment letters) must be attached to the initial EDGAR filing as separate Exhibit 99 documents. All comment letters also will be made public by the SEC staff on EDGAR. The SEC staff has clarified that each exhibit should be clearly labeled (e.g., “Confidential Amendment Draft #1”), and amendments should not be marked to show changes from previous versions.

**Resources**

*Technical Line – Implementing the JOBS Act (SCORE No. CC0348), Ernst & Young, 17 May 2012.*

*To the Point – JOBS Act to promote capital formation (SCORE No. CC0345), Ernst & Young, 23 March 2012.*
Executive compensation disclosures

Summary of issues noted
The SEC staff focuses its reviews on registrants’ Compensation Discussion and Analysis in an effort to promote more direct, specific and clear executive compensation disclosure.

Analysis of current issues
Item 402 of Regulation S-K specifies the required disclosure related to director and executive officer compensation. Item 402 disclosures are required in most proxy or information statements, as well as in Form 10-K filings and various registration statements.

The SEC staff frequently asks registrants to specifically disclose peer companies that were used for benchmarking executive compensation and specify how the peer group was established. When a benchmarking exercise is material to a registrant’s compensation program, registrants have been asked to consider confirming that all identified peers were used in the benchmarking analyses and how the pay for named executive officers compared with the benchmarks (i.e., where actual payments fell within the peer range). If actual compensation differs from targeted percentiles, the SEC staff often asks for an explanation.

The SEC staff also asks registrants to consider providing sufficient detail about how competitor information was used in making compensation decisions for named executive officers. The SEC staff routinely asks registrants to provide details on individual and corporate performance criteria and targets, both quantitative and qualitative, for each named executive. Those details include how the targets were met and how meeting those targets achieves the overall strategy of the company. If disclosing these targets would result in competitive harm, a registrant is allowed to omit the information, but must instead disclose the likelihood or the difficulty of achieving the undisclosed targets.

Example from SEC comment letter: Executive compensation disclosures
You state that the 2011 annual on-target bonus amount for each executive officer was based in part on your board members’ experience with the compensation practices of other companies and compensation survey data available from outside sources. Please identify the other companies whose compensation practices were considered by your board of directors in determining the 2011 annual on-target bonus. Tell us the criteria used in determining the other companies and describe the elements of corporate performance of the other companies that were considered in determining your executive compensation.
Item 402(s) of Regulation S-K requires a registrant to discuss and analyze its broader compensation policies and actual compensation practices for all employees, including non-executive officers, if risks arising from those compensation policies or practices are “reasonably likely to have a material adverse effect on the company.” The SEC staff often requests that registrants that do not present any Item 402(s) disclosures explain why disclosure is not necessary and describe the process they used to reach that conclusion.

Resources

To the Point – SEC requires listing standards for compensation committees (SCORE No. CC0351), Ernst & Young, 25 June 2012.

2012 proxy statements – An overview of the requirements (SCORE No. CC0339), Ernst & Young, November 2011.

Hot Topic – SEC final rule: Proxy disclosure enhancements (SCORE No. CC0289), Ernst & Young, 18 December 2009.
Guarantor financial information

Summary of issues noted

In its comments to issuers, the SEC staff frequently focuses on whether subsidiaries that guarantee parent issuer debt are 100% owned by their parent and the guarantees are full and unconditional. Recently, the SEC staff also began asking registrants about the presentation of the condensed consolidating information and the classification among columns within the condensed consolidating information.

Analysis of current issues

Debt or preferred stock registered under the Securities Act may be guaranteed by one or more affiliates of the issuer. It has become increasingly common for a parent company to raise capital through either:

- Offerings of its own securities that are guaranteed by one or more of its subsidiaries
- Offerings of securities by a subsidiary that are guaranteed by the parent company and, sometimes, one or more of the parent’s other subsidiaries

It is helpful to remember that the reporting requirements provided in Rule 3-10 of Regulation S-X provide relief from the general requirement of full separate reporting by subsidiary issuers and guarantors. If certain conditions are met, modified financial information (i.e., condensed consolidated financial information or disclosure only information) may be presented in the parent company’s financial statements.

There are five exceptions from full financial reporting included in Rule 3-10(b)-(f). However, to qualify for any of the exceptions under Rule 3-10, the subsidiary issuer or guarantor must be 100% owned by its parent company and the guarantees must be full and unconditional.

In its comments to issuers, the SEC staff seeks clarification about whether these conditions have been met, including specifically asking registrants to use the terminology in Rule 3-10 to confirm that the conditions have been met (e.g., registrants must state that the subsidiaries are 100% owned rather than “wholly-owned”). The SEC staff has focused on whether the subsidiaries are 100% owned and the guarantees are full and unconditional (e.g., whether there are release provisions associated with subsidiary guarantees).

Rule 3-10(h) provides the definitions of key terms used in Rule 3-10, including:

- 100% owned – “A subsidiary is 100% owned if all of its outstanding voting shares are owned, either directly or indirectly, by its parent company.” This would also include any potential shares (i.e., any outstanding securities convertible into its voting shares). For example, if a third party holds stock options, convertible debt, or convertible preferred shares in the subsidiary, then the 100% owned condition would not be satisfied and the subsidiary would not qualify for relief pursuant to Rule 3-10.
- Full and unconditional – “A guarantee is full and unconditional if, when an issuer of a guaranteed security has failed to make a scheduled payment, the guarantor is obligated to make the scheduled payment immediately and, if it doesn’t, any
holder of the guaranteed security may immediately bring suit directly against the guarantor for payment of all amounts due and payable.” To be full and unconditional, the guarantee may not be limited to a specific dollar amount, percentage of assets, or any other conditions beyond the issuer’s failure to pay.

**Example from SEC comment letter: Guarantor financial information**

Please enhance your disclosure to disclose, if true, that all the subsidiary guarantors are “100% owned” as defined by Rule 3-10(h)(1) of Regulation S-X. Note that “wholly-owned,” as defined in Rule 1-02(aa) of Regulation S-X, is not the same as “100% owned.” Refer to Rule 3-10(i)(8) of Regulation S-X.

In the September 2011 Center for Audit Quality’s SEC Regulation Committee meeting, the SEC staff said that a subsidiary that guarantees its parent’s debt securities under an indenture that provides for the subsidiary’s guarantee to be released automatically under customary circumstances does not meet the full and unconditional criteria. But the subsidiary still may rely on Rule 3-10 if the other requirements of Rule 3-10 are met. When subsidiary release provisions exist, the SEC staff requests additional disclosure to describe the circumstances when the subsidiary guarantor may be released.

Some examples of acceptable subsidiary guarantee release provisions include:

- The subsidiary is sold or sells all of its assets
- The subsidiary is declared “unrestricted” for covenant purposes
- The rating on the parent’s debt securities is changed to investment grade

**Example from SEC comment letter: Guarantor financial information**

We note that your indenture agreement contains certain guarantee release provisions. Please provide us with a specific and comprehensive discussion regarding how you considered these provisions in considering your reliance of Rule 3-10 of Regulation S-X.

Recently, the SEC staff has begun asking registrants about the presentation of the condensed consolidating information in accordance with Rule 3-10(i), as well as the classification among columns within the condensed consolidating information.

When companies prepare condensed consolidating financial information, Rule 3-10(i) instructs them to follow the general guidance on interim financial statements in Article 10 of Regulation S-X regarding the form and content of the condensed information, so the level of detail included should be consistent with what a registrant might include in its interim financial statements on Form 10-Q.

The rule states that the financial information should be presented in sufficient detail to allow investors to determine the nature of the assets held by, and the operations and cash flows of, each of the categories within the consolidating group. The SEC
staff has begun to ask registrants to revise their guarantor information if the condensed consolidating information does not appear to be in accordance with Article 10 of Regulation S-X (e.g., the condensed consolidating balance sheet does not include all major captions on the face of the financial statements).

The SEC staff also has recently begun asking registrants about the classification among columns within the condensed consolidating information with a particular focus on intercompany amounts. Condensed consolidating financial information must be provided in columnar format. Separate columns should depict:

- The parent company
- The subsidiary issuer(s), if applicable
- The subsidiary guarantor(s), on a combined basis
- The non-guarantor subsidiary or subsidiaries, on a combined basis
- Consolidating adjustments
- Total consolidated amounts

Additional columns may be necessary for each subsidiary issuer or guarantor that is not 100% owned, whose guarantee is not full and unconditional, or whose guarantee is not joint and several with the guarantees of other subsidiaries. The parent company column should reflect investment in all subsidiaries based on the proportionate share in their net assets and the subsidiary columns should reflect the “pushed down” basis of the parent to the extent applicable.

**Resources**

*2011 SEC annual reports – Form 10-K (SCORE No. CC0337), Ernst & Young, November 2011.*
Internal control over financial reporting and disclosure controls and procedures

Summary of issues noted

The SEC staff questions the following related to internal controls over financial reporting (ICFR) and disclosure controls and procedures:

- The nature and timely identification of material weaknesses
- The omission of disclosures about changes in ICFR when a material weakness is either identified or remediated
- The absence of disclosures about changes in internal controls after significant events that make material changes likely, such as a business combination

The SEC staff also frequently challenges the language used in interim and annual reports to describe management’s conclusions about the effectiveness of the registrant’s disclosure controls and procedures and internal control over financial reporting.

Analysis of current issues

The SEC staff has observed that registrants’ disclosure of material weaknesses often lags the development of internal control deficiencies. In many cases, material weaknesses are reported in connection with a restatement but likely existed before the related financial statement error was identified. The conclusion about the severity of a control deficiency depends on an evaluation of both the likelihood and magnitude of an error occurring without being prevented or detected by a registrant’s ICFR, not just the occurrence or magnitude of an error.

When a registrant discloses a material weakness in annual or interim filings, the SEC staff often requests more information about the material weakness, including:

- Nature and cause of the material weakness (and financial statement error, if applicable)
- Who identified the material weakness and when it was identified
- Planned actions, costs and time frame to remedy the material weakness
- How the registrant compensates for the material weakness to ensure that financial statements are free from material misstatement
- Status of any unremediated material weakness after initial disclosure

The SEC staff also questions why a registrant’s disclosures under Item 308(c) of Regulation S-K (i.e., disclosures discussing any material changes in the registrant’s ICFR) did not identify a change in internal control during the most recent quarter if a registrant (1) discloses a new material weakness or (2) reports the remediation of a previously reported material weakness.

The SEC staff challenges whether disclosures about a change in internal control under Item 308(c) of Regulation S-K should be made after a registrant acquires an entity in a business combination or has another significant event that suggests a related change in ICFR. The SEC rules require a registrant to disclose the specific changes to internal controls, if any, and not merely that a change occurred as a
result of a business acquisition. If the registrant has not completed its internal control assessment of the acquired entity, the disclosures related to all material changes resulting from a business combination since the date of the acquisition may be included in the first annual report in which the acquired business is included in the assessment.

Example from SEC comment letter: Internal control over financial reporting

We note that the acquisition of (ABC Company) has been excluded from your assessment of internal controls over financial reporting as of the year ended 2011. Please tell us what consideration you gave to disclosing any changes in internal control over financial reporting related to the acquisition that occurred during the quarter ended December 31, 2011.

Items 307 and 308 of Regulation S-K require that management’s conclusions about effectiveness explicitly state whether disclosure controls and procedures and ICFR are either “effective” or “ineffective.” Generally, the SEC staff challenges registrants that inappropriately express management’s conclusions, such as statements that disclosure controls and procedures are “adequate,” “effective, except for” or “effective except as disclosed below.”

The SEC staff also challenges registrants if management’s conclusion refers to disclosure controls and procedures in a manner that is incomplete or inconsistent with the definition under Exchange Act rules.

When restating financial statements for a particular period or when identifying an immaterial error that does not require restatement, registrants should carefully consider the effect of the restatement on previous conclusions related to the effectiveness of ICFR and its disclosure controls and procedures. If a registrant determines that ICFR or its disclosure controls and procedures (or both) were effective despite the restatement, the SEC staff may challenge the basis of these conclusions and may request additional disclosure about the rationale for such a conclusion. Although it may be possible for disclosure controls and procedures to be effective when ICFR is ineffective, the SEC staff generally questions such a conclusion given that ICFR constitutes a substantial element of disclosure controls and procedures.

Resources

2011 SEC annual reports – Form 10-K (SCORE No. CC0337), Ernst & Young, November 2011.

Management should carefully reassess the appropriateness of its prior disclosures related to internal control over financial reporting and disclosure controls and procedures.
Materiality

When assessing materiality, registrants should develop a qualitative and quantitative analysis that is specific to its facts and circumstances.

Summary of issues noted
The SEC staff continues to challenge registrants’ conclusions regarding materiality.

Analysis of current issues
SAB Topic 1-M, which is primarily codified into ASC 250-10-S99-1, includes a list of possible qualitative and quantitative factors that a registrant might consider when assessing how a reasonable investor might consider the materiality of a financial statement item, including a financial statement error. The factors listed in SAB Topic 1-M are not intended to be exhaustive, and therefore each registrant should consider all qualitative and quantitative factors that may be relevant in its circumstances, regardless of whether a factor is included in the SAB Topic 1-M examples. Evaluating whether an item is material requires judgment. Quantitative and qualitative factors should be individually considered in the materiality assessment. However, in practice it is often difficult to conclude that quantitatively large errors are immaterial based on qualitative factors. Registrants must consider qualitative factors when the error is small in magnitude. In addition, qualitative factors also should be considered when an error is quantitatively large. However, it has been unusual for a quantitatively significant error to be overcome through qualitative factors.

The SEC staff frequently requests that registrants identify the factors they considered when assessing materiality. These requests often relate to current-period and prior-period materiality assessments, when registrants assess the effect of an adjustment recorded in the current period that relates to a prior period. Registrants should avoid using a “check the box” approach to their materiality determinations and instead develop a qualitative and quantitative analysis that is specific to the registrant’s facts and circumstances. Such an analysis should consider the effects of errors on key performance indicators that may be important to investors, even if the indicators are non-GAAP measures.

Example from SEC comment letter: Materiality
Your response should also explain both the quantitative and qualitative factors that [were] considered by management in determining that this adjustment was not material to the Company’s financial statements for any of the periods presented. We may have further comment upon review of your response.
Pro forma adjustments

**Summary of issues noted**

The SEC staff frequently comments on pro forma financial information disclosed in registration statements. The SEC staff often requests that registrants provide additional information about how it has met the requirements of Article 11 of Regulation S-X, which requires pro forma adjustments to give effect to events that are (1) directly attributable to each specific transaction, (2) factually supportable and (3) expected to have a continuing impact (income statement only). The SEC has recently updated its interpretation of the definition of continuing impact, and this change is expected to be reflected in future comment letters.

**Analysis of current issues**

The objective of pro forma financial information is to help investors understand the effect of a significant transaction, such as an acquisition or disposition, that has either occurred or is probable after the date of the historical financial statements (or is not fully reflected in the historical financial statements) by showing the effect on the registrant’s historical financial statements “as if” the particular transaction occurred at an earlier time. As noted in Rule 11-02(a) of Regulation S-X, the information “should assist investors in analyzing the future prospects of the registrant because they illustrate the possible scope of the change in the registrant’s historical financial position and results of operations caused by the transaction.”

Pro forma disclosures are required in certain filings with the SEC to provide decision-useful information to investors. Article 11 of Regulation S-X describes the circumstances when pro forma information should be presented in SEC filings (i.e., registration statements, certain proxy statements, and Form 8-K filings) and the form and content for the presentation. Pro forma financial information generally includes a condensed income statement of the latest year and any subsequent interim period, a condensed balance sheet as of the end of the latest period presented (if the transaction is not yet reflected in the historical balance sheet) and accompanying explanatory notes.

**Directly attributable**

Pro forma adjustments should include only adjustments that are directly attributable to the transaction reflected in the pro forma financial information. Pro forma financial information should exclude transactions and adjustments that represent alternative courses of action.

The SEC staff recently has commented on types of adjustments that would not be directly attributable to the transaction reflected in the pro forma financial information. For example, the SEC staff has objected to eliminating goodwill impairment charges recognized by a target in a business combination for which pro forma financial information is being prepared. The SEC staff believes that the events that gave rise to the impairment are unrelated to the business combination, and historical impairment charges should not be eliminated in the pro forma financial information.
Pro forma adjustments should include only adjustments that are factually supportable. The SEC staff has indicated that an adjustment generally would be considered factually supportable if there is reliable documented evidence, such as an executed contract or completed transaction. For example, the SEC staff may challenge reflecting a new compensation arrangement in conjunction with a business combination if there is not an executed agreement. The SEC staff also has indicated that the effects of some events are too uncertain to be considered factually supportable. For example, a company would not be able to eliminate compensation expense on a pro forma basis for employees terminated in conjunction with a business combination because the related effects on revenues and operations would be too uncertain.

The SEC staff also has objected to companies reflecting the costs of being a public company when the pro forma financial information included in an IPO registration statement is required for a particular transaction unrelated to becoming a public company.

Pro forma adjustments related to the pro forma income statement also must have a continuing impact on the registrant. Historically, an item that was not expected to affect the results of operations for a period greater than 12 months from the initial occurrence was viewed as not having a continuing impact. The SEC staff has recently modified its view of continuing impact and now views items as having a continuing impact if they occur more than once.

Examples of items that may be considered to have a continuing impact under this updated view (and which previously would not) include interest expense for a bridge loan that may be incurred for a period of less than 12 months or amortization of an acquired intangible asset with a short life (e.g., six months). SEC comment letters related to this new interpretation are expected in the near future.

**Example from SEC comment letter: Pro forma adjustments**

Tell us the accounting guidance you relied on when determining this adjustment was necessary and appropriate and how you determined that the adjustment was consistent with the requirements of Article 11 of Regulation S-X.

**Resources**

*Compendium of significant accounting and reporting issues – 2011 AICPA National Conference on Current SEC and PCAOB Developments (SCORE No. CC0341)*, Ernst & Young, 12 December 2011.
Related-party transactions

Summary of issues noted
The SEC staff frequently requests that registrants expand or clarify disclosures about related-party transactions required by Item 404 of Regulation S-K.

Analysis of current issues
Item 404(a) of Regulation S-K requires registrants to describe related-party transactions (both actual and proposed) since the beginning of the registrant’s last fiscal year (1) in which the registrant is a participant, (2) which exceed $120,000 and (3) in which any related party had or will have a direct or indirect material interest.

The instructions to Item 404(a) define a related party and a transaction. The description of a particular transaction should summarize the nature of the transaction in quantitative and qualitative terms and should include any material information about the transaction. The SEC staff often requests that registrants clarify or expand their disclosures about related-party transactions as required by Item 404(a).

The SEC staff also frequently questions general statements about the materiality of related-party transactions. For example, a registrant may state that the value of a related-party transaction was “not material.” In these circumstances, the SEC staff often requests a registrant to confirm that the registrant considered the $120,000 disclosure threshold specified in Item 404(a).

Item 404(b) of Regulation S-K requires registrants to describe their policies and procedures for the review, approval or ratification of any related-party transaction required to be disclosed under Item 404(a). The SEC staff regularly asks for revised disclosures when a registrant omits, or fails to disclose all of the material features of, its policies and procedures. Examples of items to be considered include:

- The types of transactions covered by the registrant’s policies and procedures
- The standards the registrant applies under the policies and procedures
- The people who are responsible for applying the policies and procedures, including members of the board of directors
- A statement whether the policies and procedures are written, and if not, how the policies and procedures are evidenced

Registrants also should file any material agreements supporting related-party transactions described in SEC filings as required by Item 601(b) of Regulation S-K. For further discussion related to incomplete submissions of material contracts pursuant to Item 601(b), please refer to the Other SEC reporting issues topic included later in this section of the publication.

Example from SEC comment letter: Related-party transactions
Please provide further details regarding your written policy for the approval of related-party transactions. Describe the standards the audit committee applies when deciding whether to approve a related-party transaction.

Resources
2011 SEC annual reports – Form 10-K (SCORE No. CC0337), Ernst & Young, November 2011.
Summary of issues noted
The SEC staff often comments about the specificity and completeness of registrants’ risk factor disclosures. Recently, the SEC staff has focused on risks associated with cybersecurity and uncertainties related to foreign operations.

Analysis of current issues
Item 503(c) of Regulation S-K requires a registrant to disclose its significant risks and how it is affected by each of the risks. The SEC staff commonly questions risk-factor disclosures that could apply to any public company. Risk factors should be specific to the registrant’s facts and circumstances, not merely general risks that could apply to any registrant. The SEC staff also may question the completeness of a registrant’s risk factor disclosures based on information included elsewhere in the document or other public information.

Cybersecurity
In response to an increase in the frequency and severity of cyber attacks and breaches, the SEC staff provided a framework for registrants to consider in evaluating whether to disclose information about risks and incidents involving cybersecurity.

The SEC staff guidance notes that material cybersecurity risks or cyber incidents must be disclosed when necessary to avoid potential misrepresentation in other required disclosures. A registrant should consider whether potential cyber attacks, including the potential financial or reputational effects of the attacks, present a specific and material risk. The need to provide a risk-factor disclosure about cybersecurity will depend on the facts and circumstances of the registrant, the probability of the risk occurring and the risk’s magnitude. The SEC staff may question boilerplate disclosures or the completeness of a registrant’s risk factor disclosures, if information included elsewhere in the filing or other public information indicates that material cybersecurity risks exist. For example, the staff may request enhanced disclosure if a registrant discusses a material cyber incident in a press release, but does not discuss the risks associated with the incident in an SEC filing.

Example from SEC comment letter: Cybersecurity
You disclose that you recognize that cyber risks and vulnerabilities continue to evolve and that developing and maintaining adequate security measures may present significant challenges not only for you, but also for third parties with which you do business. Accordingly, it appears that your business has been subject to cyber risks. If you have experienced attacks in the past, please expand your risk factor to state that.
Foreign operations

Many registrants have foreign operations subject to material political and currency risks or other uncertainties. The SEC staff often questions registrants’ disclosures of risks and uncertainties related to foreign operations, such as the debt crisis in Europe and material risks associated with countries determined to be sponsors of terrorist activities. The SEC staff requests that registrants provide more detailed disclosures about the current and potential effect of those risks and uncertainties (e.g., past due receivables in Italy and Spain).

Registrants also should consider the SEC staff comments issued about liquidity and results of operations related to foreign operations. For further discussion, refer to the Liquidity and capital resources and State sponsors of terrorism sections of this publication.

Resources

2011 SEC annual reports – Form 10-K (SCORE No. CC0337), Ernst & Young, November 2011.

To the Point – SEC staff issues guidance on cybersecurity disclosures (SCORE No. CC0340), Ernst & Young, 20 October 2011.
**Summary of issues noted**
The SEC staff is focusing on registrants with foreign operations in countries identified as state sponsors of terrorism.

**Analysis of current issues**
The SEC staff comments on disclosures about liquidity, risk factors and results of operations for registrants with foreign operations in countries that have been identified by the US Department of State as state sponsors of terrorism. Certain investors and governmental entities have implemented divestment initiatives for registrants that conduct business with these countries. Therefore, the SEC staff is asking companies with material operations in these countries to disclose information that reasonable investors would consider important to make investment decisions.

To identify registrants with operations in these countries, the SEC staff is reviewing a variety of sources, including company websites (e.g., company location and contact listings) and press releases. The countries that are the primary focus of the SEC staff’s comments include Syria, Iran, Cuba and Sudan.

The SEC staff requests that registrants provide the following information to determine the materiality of operations in these countries and the necessity for additional disclosure in MD&A:

- Description of the nature and extent of past, current and anticipated contacts within the relevant countries, whether through affiliates, subsidiaries or other arrangements
- Description of services or products provided to these countries and any agreements, commercial arrangements or government contacts
- Materiality assessment of contacts with these countries and whether they are a material investment risk for investors, including:
  - Quantitative analysis of associated revenues, assets and liabilities for the last three fiscal years and subsequent interim period
  - Qualitative factors that would affect an investment decision, including the potential impact on the company’s reputation and share value

Based on the quantitative and qualitative materiality assessments, the SEC staff may ask registrants to include additional disclosures about these operations in their annual and quarterly Exchange Act filings.

In addition to these requests for information, President Barack Obama recently signed the Iran Threat Reduction and Syria Human Rights Act of 2012 on 10 August 2012 that, among other things, will require public companies to disclose in their annual and quarterly reports filed with the SEC whether they or their affiliates knowingly engaged in various prohibited activities involving Iran. These disclosures are required in annual and quarterly reports filed with the SEC 180 days after enactment, so registrants should consider the inclusion of such disclosures, if applicable.
Summary of issues noted
XBRL exhibit omissions affect the timeliness of a company’s reporting and may trigger comments from the SEC staff. Significant and recurring errors in XBRL exhibits also have been noted in SEC staff observation reports.

Analysis of current issues
Since 2009, the SEC has required issuers to submit XBRL exhibits for periodic annual and quarterly filings (e.g., Forms 10-Q, 10-K, 20-F, and 40-F) and certain Securities Act registration statements. The requirement to file XBRL exhibits has been phased in for registrants from 2009 to 2011.

The XBRL initiative, which requires companies to provide computer-readable identifying tags for each item of data in the financial statements, notes and schedules, is intended to make it easier for investors to analyze and compare financial information.

XBRL exhibit omissions affect the timeliness of a company’s reporting and may trigger comments from the SEC staff. If a registrant does not make the required XBRL exhibit submission, the registrant will not be considered current for purposes of determining eligibility to use short-form registration (e.g., Form S-3).

Other than commenting on the completeness of a registrant’s XBRL submission, the SEC staff from the Division of Corporation Finance is not currently including comments on XBRL exhibits submitted by registrants in its comment letters. However, the SEC staff may begin issuing comment letters on XBRL exhibits in the near future.

The SEC staff from the Division of Risk, Strategy, and Financial Innovation performs select reviews of interactive data submissions and has noted several significant and recurring errors. The SEC staff summarized significant and recurring errors in XBRL exhibits in four sets of Staff Observations reports issued over the past two years. Registrants should focus on avoiding these errors in their next interactive data submission. Registrants can use the AICPA issued *Principles and Criteria for XBRL – Formatted Information*, which can help improve the quality of the financial information they format in computer-readable XBRL and submit to the SEC and other regulators.

On 2 July 2012, EDGAR stopped accepting XBRL exhibits using the 2009 US GAAP XBRL Taxonomy. Registrants may continue to use the 2011 US GAAP XBRL Taxonomy, but the SEC staff strongly encourages companies to adopt the latest version for their XBRL exhibits, which is the 2012 taxonomy released in March 2012.

Detail-tagging
Form 10-Ks for 2012 will mark the first period that all SEC registrants will be required to meet the SEC mandate for detail tagging. Many accelerated and non-accelerated registrants will find compliance challenging. Whether filers outsource the tagging to a third party or create XBRL exhibits in-house, understanding the requirements to make informed decisions during the creation and review of the XBRL-tagged financials is vital, especially once the limited liability provisions expire 24 months after a registrant’s initial submission.
Registration statements

The SEC staff also has identified several significant and recurring errors that registrants are making in XBRL exhibits submitted as part of registration statements (i.e., not incorporated by reference).

These errors include (1) failing to include XBRL exhibits with non-IPO registration statements once a price or price range has been determined and (2) including XBRL exhibits when not permitted (e.g., in a prospectus filed pursuant to Rule 424(b) under the Securities Act of 1933).

Although the SEC has required the use of XBRL for more than two years, these problems are surfacing now because non-accelerated filers, including new public companies, must include XBRL exhibits as part of registration statements. That’s because they may not be eligible to incorporate by reference and did not have to comply with the XBRL mandate until mid-2011.

Resources

Technical Line – New principles and criteria for assessing the quality of XBRL files (SCORE No. EE0906), Ernst & Young, 23 August 2012.


Technical Line – How to avoid XBRL errors in certain registration statements (SCORE No. CC0344), Ernst & Young, 26 January 2012.

2011 SEC annual reports – Form 10-K (SCORE No. CC0337), Ernst & Young, November 2011.

To the Point – SEC staff outlines common XBRL submission errors (SCORE No. CC0326), Ernst & Young, 23 June 2011.

To the Point – Key insights for companies with new XBRL requirements (SCORE No. CC0321), Ernst & Young, 21 April 2011.
Other SEC reporting issues

Summary of issues noted
The SEC staff often questions the completeness and compliance of the electronic documents filed by a registrant on EDGAR. Omissions or deficiencies in exhibits or the audit report may trigger comments from the SEC staff.

Analysis of current issues
The SEC staff commonly asks registrants to file missing schedules or exhibits to correct incomplete EDGAR submissions of material contracts required by Item 601(b)(10) of Regulation S-K (e.g., a credit agreement should include all of its schedules and exhibits). Registrants often are able to provide the missing information in a subsequent filing rather than by amending the original filing.

The SEC staff also has noted a number of instances in which the conformed signature of the accounting firm did not appear on the "Report of Independent Registered Public Accounting Firm" or the consent to the use of that report in a Securities Act registration statement. These deficiencies often require amendment of the registrant's Form 10-K.

Example from SEC comment letter: Other SEC reporting issues
We note that the report of your Independent Registered Public Accounting Firm is not signed. Please amend your filing to provide a report from your Independent Registered Public Accounting Firm that is signed. Refer to Item 2-02(a) of Regulation S-X and Item 302 of Regulation S-T which provides guidance on including signatures in electronic filings.

Resources
2011 SEC annual reports – Form 10-K (SCORE No. CC0337), Ernst & Young, November 2011.
The SEC staff commonly challenges the income statement presentation of revenue and related costs attributable to various products and services.

**Rule 5-03(b)**

**Summary of issues noted**

The SEC staff asks registrants to provide information supporting their conclusions on the appropriate presentation of revenue and cost of sales in the income statement. Specifically, the SEC staff focuses on the income statement presentation guidance in Rule 5-03(b)(1) of Regulation S-X.

**Analysis of current issues**

Many registrants derive revenues from the sale of different product categories, or the sale of both products and services. In such cases, presentation of revenues by category may provide meaningful information to the users of the financial statements, particularly if the gross margins of the various categories of transactions are disparate. Rule 5-03(b)(1) of Regulation S-X requires the following items to be separately stated on the face of the income statement, unless the amount is less than 10% of the total of these subcaptions:

- Net sales of tangible products (gross sales less discounts, returns and allowances)
- Operating revenue of public utilities or others
- Rental income
- Revenue from services
- Other revenues

Rule 5-03(b)(2) of Regulation S-X requires that costs and expenses applicable to sales and revenues be presented on the face of the income statement in categories similar to the revenue categories above.

The SEC staff asks registrants to provide their analyses and other information, including quantitative data by revenue source, that was used to conclude on the presentation of revenue and cost of sales. Registrants should continuously monitor the revenue earned from each source to ensure they are properly presenting revenue and cost of sales attributable to the various offerings.

**Example from SEC comment letter: Rule 5-03(b)**

Reference is made to your presentation of revenues from your business operations under the caption “Sales” on the face of your income statements. We note from your disclosures that you provide a broad range of goods and services. In this regard, please advise why you believe your presentation of revenues in the aggregate on the face of the income statement is appropriate as it appears that you recognize both product and service revenues from your business operations. As part of your response, please address how your presentation complies with the guidance outlined in Rule 5-03(b)(1), and provide us with a break out of product and services revenues which comprise total sales for each of the periods presented. Alternatively, you may revise your income statement presentation to separately state revenues from products and services, including the related costs of revenues.
Classification of costs

Summary of issues noted
The SEC staff regularly challenges registrants’ disclosures about the classification of various costs on the income statement.

Analysis of current issues
The SEC staff asks registrants to disclose the types of costs they include in cost of sales and in selling, general and administrative (SG&A) expenses on their income statements. Specifically, the SEC staff questions whether registrants have included inbound freight charges, purchasing and receiving costs, inspection costs, warehouse costs, internal transfer costs and other distribution costs in cost of sales. The SEC staff also requests that registrants that exclude these costs from cost of sales disclose in MD&A that their gross margins may not be comparable to those of other entities because some entities include these costs in cost of sales.

ASC 605-45 indicates that the classification of shipping and handling costs in either cost of sales or SG&A expense is an accounting policy decision that should be disclosed according to ASC 235. Shipping costs are incurred to physically move products from the seller’s place of business to the buyer’s designated location. Handling costs are incurred to store, move and prepare the products for shipment. If shipping and handling costs are material and a registrant excludes these costs from cost of sales, the registrant should disclose in the notes to the financial statements the line item(s) on the income statement that include these costs and the amount of such costs (ASC 605-45-50-2).

The SEC staff also issues comments to registrants that do not include depreciation and amortization expense in cost of sales. The SEC staff requests that registrants that present a gross profit measure either (1) allocate the appropriate amount of depreciation and amortization expense to cost of sales or (2) revise the description of the gross profit line item in accordance with SAB Topic 11-B to make it clear that cost of sales excludes depreciation and amortization expense.
Statement of cash flows classification and presentation

**Summary of issues noted**

The SEC staff asks registrants to explain the basis for the classification of certain items in the statement of cash flows and to revise future filings when their reconciliation of net cash flows from operating activities begins with a financial metric other than net income.

**Analysis of current issues**

The SEC staff asks registrants to explain the classification basis for items in the statement of cash flows (i.e., operating, investing or financing). Guidance on appropriate classification of cash flows provided in ASC 230 is explicit with respect to the proper classification of certain items; other items require registrants to apply judgment. When the classification of a particular item is not clearly addressed in the relevant accounting guidance, the SEC staff often requests that registrants explain the judgment applied in determining the classification. The SEC staff has cautioned that if the most appropriate classification is not clear, it does not mean that any classification is appropriate. Rather, registrants must analyze the nature of the activity and the predominant source of the related cash flows.

ASC 230 requires entities choosing to apply the indirect cash flow method to begin with net income when presenting the reconciliation to net cash flows from operating activities. The SEC staff requests that registrants revise their future filings when the reconciliation inappropriately begins with income attributable to the controlling shareholder (e.g., the parent), income before the results of discontinued operations or any amount other than net income.

**Resources**

*Financial reporting developments – Statement of cash flows – Accounting Standards Codification 230 (SCORE No. 42856), Ernst & Young, May 2012.*
Summary of issues noted
The SEC staff commonly asks registrants to provide, in both the financial statements and MD&A, a robust description of the accounting policies and methods used to estimate the allowance for doubtful accounts. The SEC staff also asks registrants to explain unusual fluctuations in historical financial relationships, such as the allowance for doubtful accounts as a percentage of the accounts receivable balance.

Analysis of current issues
ASC 310 provides the basic disclosure requirements for accounts receivable. Registrants with sales that result in accounts receivable should have accounting policies and methods to estimate an allowance for doubtful accounts. They also should have policies for writing off uncollectible trade receivables. The SEC staff has requested detailed disclosures about how a registrant determines its allowance for doubtful accounts, including the significant assumptions used.

When conditions cause significant or unusual changes in accounts receivable or in the allowance for doubtful accounts, the SEC staff requests that registrants disclose factors that led to the changes, why the balances changed so significantly, whether any specific customers caused the changes and what steps management has taken to collect outstanding balances.

Financial ratios and relationships for which the SEC staff often requests additional information include:

- The relationship between revenue amounts, accounts receivable balances and allowances for doubtful accounts, including the reasons for any changes in these relationships over time
- Changes in the balance of accounts receivable from one reporting period to the next, and the effects of those changes on cash flows from operating activities
- Policies for extending credit and how those policies affect the accounts receivable and allowance balances
- The number of days’ sales in accounts receivable, including any differences between that amount and the registrant’s standard credit terms
- Changes in coverage ratios (e.g., the ratio of allowance for doubtful accounts to accounts receivable) from one reporting period to the next
Summary of issues noted

The SEC staff asks registrants to provide more detailed disclosures about receivables from government and nongovernment entities, particularly those in European countries experiencing economic challenges.

Analysis of current issues

The SEC staff has begun asking questions about registrants’ disclosures of exposures to government-owned or -supported customers. In cases where registrants have past due receivables from government-owned or -supported customers in certain European countries, the SEC staff requests registrants to provide:

- Information on the aging of the receivables by country
- The amount of the allowance for uncollectible accounts by country
- The basis for the conclusion that the allowance adequately addresses the collectibility of current and past-due receivables for these customers

Recently, exposures to European nongovernment entities also have become a concern. As a result, the SEC staff also has focused on how a registrant has considered the European financial crisis in its estimation of the allowance for bad debts.

Example from SEC comment letter: Accounts receivable from European entities

We note your disclosure of your concentration of sales to European countries. Considering the European sovereign debt crisis and economic conditions and your concentrations in sales in these foreign countries, please explain in more detail how you have assessed your outstanding accounts receivable balances for potential impairment.

The SEC staff has reminded registrants to consider CF Disclosure Guidance: Topic No. 4: European Sovereign Debt Exposures that it issued in January 2012 to help registrants determine what they should disclose about their exposures to countries experiencing significant economic, fiscal or political challenges, when default is more likely to occur than if such factors did not exist.

The SEC staff’s guidance does not list the specific countries subject to enhanced disclosure. Instead, the SEC staff expects registrants to use their own judgment. The countries for which these disclosures are made will change as risks change over time. Registrants should disclose their basis for identifying countries included in their enhanced disclosure.

Resources

Quarterly summary of current SEC activities — SEC in Focus (SCORE No. CC0346), Ernst & Young, April 2012.

Compendium of significant accounting and reporting issues — 2011 AICPA National Conference on Current SEC and PCAOB Developments (SCORE No. CC0341), Ernst & Young, 12 December 2011.

Summary of issues noted
The SEC staff frequently requests that registrants enhance or explain their existing business combinations disclosure by:

- Including all of the detailed disclosure requirements listed in ASC 805, specifically, the pro forma information required by ASC 805-10-50-2(h)
- Providing supplemental information and expanding disclosures about contingent consideration arrangements
- Providing supplemental information about how the registrant identified and determined the fair value of acquired intangible assets, especially when goodwill represents a large portion of the consideration transferred

Analysis of current issues
General disclosures
The disclosures in ASC 805 are intended to enable financial statement users to evaluate:

- The nature and financial effect of business combinations that occur (1) during the current reporting period or (2) after the balance sheet date but before the financial statements are issued
- The financial effects of adjustments recognized in the current reporting period that relate to a business combination that occurred in the current or previous reporting periods

The SEC staff often challenges whether registrants’ disclosures about business combinations are sufficient. In doing so, the SEC staff frequently requests that registrants expand the disclosures to provide all information listed in ASC 805.

Example from SEC comment letter: General disclosures
Please ensure that you provide all of the disclosures required by ASC 805-10-50, ASC 805-20-50, and ASC 805-30-50 for the acquisition of ABC Company. For example, please disclose the amount of acquisition-related costs incurred and the corresponding line items these costs have been reflected in pursuant to ASC 805-10-50-2(f).

The SEC staff frequently requests that registrants include all pro forma disclosures required by ASC 805-10-50-2(h), 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 may ask the registrant to explain why it is impractical for the registrant to prepare the disclosures or to provide a supplemental calculation to support the registrant’s assertion that the acquisition is not material.
The SEC staff often challenges whether additional intangible assets should have been recognized, especially when a significant portion of the purchase price has been allocated to goodwill.

### Example from SEC comment letter: General disclosures

Please also provide the supplemental pro forma information showing the revenue and earnings of the combined entity for the current and prior reporting periods as though the acquisition dates for all business combinations that occurred in each year had been as of the beginning of that year. Please refer to ASC 805-10-50-2(h).

### Contingent consideration arrangements

The SEC staff asks registrants to provide more robust descriptions of any contingent consideration arrangements and the basis for estimating the amounts of the payments. The SEC staff asks registrants to explain how they account for and determine the fair value of contingent payments to former owners both as of the acquisition date and in subsequent periods (including whether payments represent compensation or consideration). The SEC staff may request that registrants enhance their disclosures based on its review.

### Identification and valuation of acquired intangible assets

The SEC staff frequently challenges whether additional intangible assets should have been recognized in a business combination and whether the value assigned to acquired intangible assets is appropriate. This is particularly true when registrants have allocated a significant portion of the purchase price to goodwill. For further discussion, please refer to the Intangible assets section of this publication.

### Resources

*Financial reporting developments – Business combinations (SCORE No. BB1616), Ernst & Young, September 2011.*
Contingencies

Accounting for and disclosure of loss contingencies

Summary of issues noted

In the SEC staff’s comments on registrants’ compliance with loss contingency disclosure requirements, it focuses on disclosures for reasonably possible losses, the clarity and timeliness of loss contingency disclosures and policies for accruing legal costs.

Analysis of current issues

The SEC staff frequently challenges registrants for failing to make required footnote disclosures when losses are considered reasonably possible, or for failing to disclose the range of reasonably possible losses, including when there is a reasonable possibility of a loss in excess of the amount accrued. The SEC staff seeks to verify that a registrant has considered and disclosed an estimate of the amount or range of reasonably possible losses, or, if applicable, a statement that the amount of loss cannot be estimated.

The SEC staff generally has not objected when registrants comply with the ASC 450 disclosure requirements for ranges of reasonably possible losses by disclosing either of the following:

• The amount or range of reasonably possible losses on an aggregate basis

• The amount or range of reasonably possible losses in certain cases and a statement that the registrant cannot estimate an amount for other cases

The SEC staff consistently questions registrants about how they determine that an estimate or range of loss cannot be made in a reporting period. If a registrant cannot make an estimate, the SEC staff expects it to support the conclusion with a sufficient process.

Example from SEC comment letter: Accounting for and disclosure of loss contingencies

If you conclude that you cannot estimate the reasonably possible additional loss or range of loss, please supplementally: (1) explain to us the procedures you undertake on a quarterly basis to attempt to develop a range or reasonably possible loss for disclosure and (2) for each material matter, what specific factors are causing the inability to estimate and when you expect those factors to be alleviated.

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

2 While it is acceptable to aggregate the amount or range of all reasonably possible losses, the SEC staff has objected to the aggregation of all loss categories (i.e., it is not acceptable to disclose one estimate combining probable, reasonably possible and remote loss contingencies).
The SEC staff requests that a registrant’s disclosures use terms that are consistent with the language in ASC 450 when discussing the likelihood of occurrence (i.e., probable, reasonably possible or remote) and the estimated reasonably possible loss (i.e., additional loss, range of loss, an estimate cannot be made or the estimated additional loss or range of loss is not material).

The SEC staff also expects management to evaluate its loss contingency disclosures (or lack thereof) each reporting period, and expects those disclosures to evolve to include more quantitative information as the loss contingency progresses. The SEC staff sometimes issues comments on the same matter in subsequent annual and quarterly periods. Further, the SEC staff frequently challenges the adequacy of historical disclosures when loss contingencies have been settled. In particular, the SEC staff reviews prior-period disclosures and inquires whether disclosures were appropriate in the past and whether an accrual should have been recognized in a prior period.

The SEC staff also asks registrants about their accounting policy for accruing for legal costs associated with their loss contingencies and, to the extent material, may request that a registrant disclose such a policy in future filings.

**Resources**

*Compendium of significant accounting and reporting issues – 2011 AICPA National Conference on Current SEC and PCAOB Developments (SCORE No. CC0341), Ernst & Young, 12 December 2011.*
Modifications, exchanges, extinguishments or troubled debt restructurings

The SEC staff may request detailed analyses and calculations to support a registrant’s accounting conclusions when a transaction represents a debt exchange or modification.

**Summary of issues noted**
Registrants evaluate their liquidity and debt positions, often leading to agreements to modify, exchange or extinguish existing debt. The SEC staff focuses on the accounting for debt modifications or exchanges, including whether the transaction was a troubled debt restructuring. The SEC staff also may ask registrants to provide detailed analyses and related calculations to support their modification and extinguishment conclusions.

**Analysis of current issues**
The accounting differs significantly depending on whether the transaction is a modification, extinguishment or troubled debt restructuring (TDR). Registrants should consider the guidance in ASC 470-50 when evaluating debt modifications and should be prepared to provide a thorough accounting analysis for the transaction in response to probing questions from the SEC staff. The SEC staff requests further explanation about:

- How a modification or exchange was considered under the guidance on TDRs in ASC 470-60
- The inclusion or exclusion of certain fees in the 10% cash flow test, such as fees paid to lenders and fees paid to third parties
- The calculation of a gain on a modification accounted for as an extinguishment, including the assumptions used to calculate fair value both before and after the modification and how the calculation of the gain is affected by the cash conversion guidance in ASC 470-20
- The determination of the effective interest rate used in the quantitative tests
- The accounting treatment of transaction fees subsequent to the determination of modification versus extinguishment accounting
- How the calculation of gain or loss on extinguishment was affected by the issuance of other instruments (such as preferred stock and successor common stock) for the restructuring
- Details about the write-off of debt discounts and why it was appropriate to record the write-off
Summary of issues noted
The SEC staff comments on fair value measurements and the required disclosures in ASC 820. Many of the SEC staff’s comments focus on how registrants:

- Validate third-party information from pricing services, brokers and appraisers
- Categorize their fair value measurements within the fair value hierarchy
- Disclose information about the valuation techniques and inputs used for their Level 2 and Level 3 measurements
- Disclose nonrecurring fair value measurements, such as impairments

The new fair value disclosures in ASU 2011-04, primarily related to Level 3 measurements, are becoming an area of focus for the SEC staff as well.

Analysis of current issues
Use of third-party information
The use of third-party pricing information from brokers and pricing services is an area of inquiry for the SEC staff not only for financial institutions, but also for registrants in all industries that rely on this information to measure fair value. The SEC staff has requested that registrants provide additional disclosures in this area, including:

- The extent that the information provided by third parties is based on observable market data, or unobservable inputs or proprietary models
- The procedures companies use to validate the information received from third parties and to evaluate the accuracy and completeness of the inputs used
- The process for adjusting prices provided by third parties and the basis for any adjustments made
- Any caveats or disclaimers about the pricing information received from the third parties

In addition to brokers and pricing services, recent SEC staff comments indicate it is particularly focused on the use of third-party appraisals to determine the fair value of a variety of assets, including impaired loans and foreclosed real estate. The SEC staff commonly asks questions about:

- How frequently third-party appraisals are obtained and updated
- The type of appraisals obtained (e.g., “as is” value) and the processes registrants have for evaluating the information provided
- Additional detail about the types of adjustments made to the appraised values, including any made as a result of outdated appraisals
- Quantitative information about the amount of assets (e.g., collateral-dependent loans) for which an appraisal serves as the registrant’s primary basis for its valuation
Regardless of whether third-party pricing information is obtained from brokers, pricing services or appraisers to determine fair value, the SEC staff remains interested in how registrants determine the appropriate level within the fair value hierarchy to classify those assets and liabilities.

*Fair value hierarchy classification*

Inquiries by the SEC staff about the categorization of assets and liabilities within the fair value hierarchy levels go beyond those items measured primarily using third-party pricing information. Registrants also have been questioned about their basis for classifying certain assets or liabilities in a particular category in the hierarchy when the measurement is determined internally.

In certain instances, the SEC staff may challenge classifications it considers inappropriate. For example, the SEC staff remains skeptical about classifications of certain instruments, such as loans and warrants, as Level 2 (rather than Level 3). The SEC staff also has raised questions about registrants’ processes for addressing transfers between hierarchy categories.

*Valuation techniques and inputs*

The SEC staff asks registrants to provide more robust disclosures about the valuation techniques and inputs they use in determining fair value. The SEC staff also questions registrants about fair value measurements determined using multiple valuation techniques. For example, it is not uncommon for the SEC staff to inquire about the “weighting” assigned to multiple value indications when registrants used more than one valuation technique (e.g., internal model valuations, pricing indications from independent sources).

*Nonrecurring fair value measurements*

The SEC staff reminds registrants about the disclosures required by ASC 820-10-50-5 for nonrecurring fair value measurements. In addition, as it pertains to the measurement of foreclosed real estate, the SEC staff is focused on the timing of when write-downs are taken.

Given the requirement in ASC 310 to measure loans at fair value less costs to sell when foreclosure is probable, some registrants have received inquiries regarding the magnitude of write-downs taken on assets classified as “other real estate owned.” In these instances, the SEC staff requests that registrants provide information indicating whether deterioration in the fair value of these assets has occurred subsequent to the foreclosure and to provide more information about the factors driving these subsequent impairments in future filings.
Other considerations

ASU 2011-04 was issued in May 2011 and became effective for registrants in the quarter ended 31 March 2012. This ASU requires a number of new fair value disclosures, primarily related to Level 3 measurements. ASU 2011-04 explicitly requires companies to provide quantitative information about the significant unobservable inputs used in their Level 3 measurements, in addition to describing their valuation processes related to these measurements and the sensitivity of their recurring Level 3 measures to changes in the unobservable inputs disclosed. The SEC staff has already begun questioning registrants about how they complied with the new disclosure requirements and in certain cases specifically requested that future filings include weighted average information for the significant unobservable inputs disclosed.

Resources

The new fair value disclosures: A snapshot of how public companies adopted the disclosure requirements of ASU 2011-04 (SCORE No. BB2375), Ernst & Young, 10 July 2012.

Financial reporting developments — Fair value measurement (SCORE No. BB1462), Ernst & Young, January 2012.

Practical matters for the c-suite — SEC reminder: management is responsible for the output provided by third-party pricing services (SCORE No. BB2270), Ernst & Young, 26 January 2012.
Redeemable equity instruments and redeemable noncontrolling interests

**Summary of issues noted**

The SEC staff frequently issues comments relating to the accounting for “redeemable equity instruments” and “redeemable noncontrolling interests.” Redeemable equity instruments of a parent, as well as noncontrolling interests of a subsidiary that are subject to put rights (or perhaps a combination of put and call rights) or a forward purchase agreement, are relatively common.

**Analysis of current issues**

Redeemable equity instruments (e.g., preferred shares) often are required to be classified in the temporary equity or “mezzanine” section of the balance sheet and measured at, or accreted to, their redemption values. The accounting for these instruments is complex and based, in part, on the nature of the redemption feature.

Holders or issuers of a noncontrolling interest may have many reasons to contractually agree to sell or buy the noncontrolling interest at some point in the future through a contractual redemption feature. The accounting in this area is complex because of the interaction of the form of the redemption feature (i.e., whether it is embedded or freestanding), the nature of the redemption feature (option-like or forward-like) and the pricing of the redemption feature (fixed, variable or fair value), as well as the different guidance that must be considered.

The SEC staff’s comments often request clarification of the disclosures required by Rule 5-02.27 of Regulation S-X, including a description of the redemption features, the accounting treatment and an explanation of any difference between the carrying amount and redemption value.

The primary literature to be considered includes ASC 480, ASC 815 and the SEC’s guidance in ASC 480-10-S99-1 and ASC 480-10-S99-3A.

**Resources**

*Financial reporting developments – Derivative instruments and hedging activities (SCORE No. BB0977)*, Ernst & Young, November 2011.

*Financial reporting developments – Noncontrolling interests in consolidated financial statements (SCORE No. BB1577)*, Ernst & Young, July 2011.
Summary of issues noted

The SEC staff often focuses on the classification and measurement of equity derivatives and convertible instruments that may be settled in a registrant’s own stock. The SEC staff frequently inquires about those instruments upon issuance or when their terms are modified, given the size or importance of the transaction, but may provide comments any time throughout their term.

Analysis of current issues

The SEC staff emphasizes the need for registrants to perform a thorough analysis of these arrangements when applying the guidance in ASC 815-40-15 (indexation guidance) and ASC 815-40-25 (equity classification guidance) to the accounting for freestanding and embedded equity derivatives.

For convertible instruments that do not require bifurcation of the conversion feature, the SEC staff inquires about the consideration of the other accounting models that can result in separate accounting for the conversion feature, including the guidance in ASC 470-20 on cash conversion and beneficial conversion features.

Historically, the SEC staff has asked broad, open-ended questions about how the accounting literature was considered whenever equity derivatives or convertible instruments were issued. While it continues to ask these questions, the recent trend in the SEC staff’s comments has been more focused on how a registrant applied specific elements of the guidance or how a specific feature or provision of a financial instrument was analyzed under the relevant guidance.

A registrant’s analysis of an equity-related derivative or convertible instrument requires it to consider guidance in ASC 470-20, ASC 480 and ASC 815-40. The SEC staff often identifies issues related to:

- Classification guidance in ASC 815-40-25, when analyzing a warrant or conversion option for possible equity classification (or an exception from derivative accounting) based on a “theoretical possibility” that the issuer could be forced or assumed to settle in cash
- How a contract settles (e.g., net-share settlement versus net-cash settlement) and who controls the choice of settlement form under ISDA Agreements for equity derivative contracts when applying ASC 815-40-25-1 through 25-4
- Whether settlement of the instrument is required in registered shares and, if so, whether the shares can be issued under existing effective registration statements when applying ASC 815-40-25-11 through 25-18
- Whether all outstanding instruments with share delivery obligations were considered in calculating “sufficient authorized and unissued shares” under ASC 815-40-25-19 through 25-24

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3 International Swaps and Derivatives Association (ISDA) Master Agreements and ISDA Definitions (collectively, the ISDA Agreements).
Adjustment provisions that can change the settlement amount of an equity-linked instrument or feature, and whether the adjustments are allowed under ASC 815-40-15

Valuation of the liability component of cash convertible debt instruments according to ASC 470-20

Beneficial conversion features under the relevant guidance in ASC 470-20

Puttable warrants and other similar instruments that can be settled in redeemable shares under ASC 480-10-25-8 through 25-13 and ASC 480-10-55-33

Specifically, the SEC staff comments on:

- The terms and conditions of adjustment provisions that would change the exercise price of an equity-linked instrument or embedded feature and the registrant’s analysis of these provisions under the indexation guidance in ASC 815-40-15
- The existence of adjustment provisions intended to protect the holder from declines in the stock price (i.e., a down-round provision) or if the exercise prices are denominated in a foreign currency that affects the analysis under the classification guidance in ASC 815-40-25
- The registrant’s consideration of factors in determining the nature of the host instrument in convertible preferred stock
- The registrant’s use of a sequencing method under ASC 815-40-35-12 and 35-13 in partially reclassifying an instrument from equity to a liability on a subsequent assessment of the instrument’s classification
- How prepayment options and other embedded features were considered in determining the fair value and the expected life of the liability component of cash convertible instruments

**Fair value considerations**

The SEC staff also challenges the model and inputs used to calculate fair value for equity derivatives. For example, the SEC staff has challenged the use of the Black-Scholes valuation model when valuing warrants that include certain price protection or other adjustment provisions. It also has requested explanations about why other models, such as the binomial or lattice model, were not used. This is likely because the limited inputs and assumptions used in the Black-Scholes model do not capture all of the contractual terms that affect the instrument’s fair value.

The SEC staff also requests more information about how the fair value measurement guidance in ASC 820 was applied and how fair value was allocated to various instruments that involve both debt and equity components.
Resources

Financial reporting developments – Derivative instruments and hedging activities (SCORE No. BB0977), Ernst & Young, November 2011.

Technical Line – Tranched preferred share issuances (SCORE No. BB1858), Ernst & Young, 11 November 2009.

Technical Line – Warrants on redeemable shares (SCORE No. BB1844), Ernst & Young, 21 October 2009.

Hot Topic – Accounting for convertible debt instruments that may be settled in cash upon conversion (SCORE No. BB1522), Ernst & Young, 28 May 2008.


Technical Line – Implementation issues related to FASB Staff Position APB 14-1 (SCORE No. BB1623), Ernst & Young, 12 November 2008.
Summary of issues noted
The SEC staff’s requests for additional information about goodwill include:

- Challenges of disclosures about reporting units that may be at risk of goodwill impairment and the timing of impairment losses
- Requests for supplemental information about registrants’ impairment testing policies
- Requests for registrants to disclose more information about their goodwill impairment testing policies

The new qualitative assessment for testing goodwill for impairment may be an area of focus for SEC staff comments in the future.

Analysis of current issues
Reporting units “at risk” of impairment
The SEC staff frequently requests that registrants discuss in MD&A the possibility of future impairment of goodwill for any reporting unit with an estimated fair value that does not substantially exceed its carrying value (i.e., the reporting unit is at risk of failing a future Step 1 impairment test under ASC 350). This is particularly true when the registrant’s operating results (or that of the relevant segment) have declined significantly.

Example from SEC comment letter: Reporting units “at risk” of impairment
To the extent that any of your reporting units have estimated fair values that are not substantially in excess of the carrying value and to the extent that goodwill for these reporting units, in the aggregate or individually, if impaired, could materially impact your operating results (or that of the relevant segment) have declined significantly:

- Identify the reporting unit
- The percentage by which fair value exceeds the carrying value as of the most recent step-one test
- The amount of goodwill
- A description of the assumptions that drive the estimated fair value
- A discussion of the uncertainty associated with the key assumptions
- A discussion of any potential events and/or circumstances that could have a negative effect on the estimated fair value

While no bright lines exist to determine whether a reporting unit’s goodwill is “at risk,” the SEC staff has stated that it expects a registrant to apply judgment when making disclosures. If goodwill impairment is a critical accounting estimate but the registrant does not have any reporting units that are at risk of failing the Step 1 goodwill impairment test, the SEC staff would expect the registrant to disclose that fact.
The SEC staff challenges the timing of a goodwill impairment charge, particularly when the reasons for the charge also existed in prior periods.

The SEC staff also may question whether adequate disclosure was made in previous filings when a goodwill impairment charge is recorded for a reporting unit that was not previously disclosed as being at risk.

Supplemental information on impairment analysis
During the comment process, the SEC staff frequently asks for supplemental information about a registrant’s impairment analysis, including:

- Details of the goodwill impairment analysis for each reporting unit, including how reporting units are identified and how assets, liabilities and goodwill are assigned to reporting units
- Sensitivity analyses regarding material assumptions used in assessing recoverability of goodwill, including qualitative and quantitative factors, and how changes in those assumptions might affect the outcome of the goodwill impairment test
- The reconciliation of the aggregate fair values of the reporting units to the registrant’s market capitalization, and justification of the implied control premium, including relevant transactions reviewed to support the control premium
- Details of the registrant’s analysis of events that have occurred since the latest annual goodwill impairment assessment and whether those events are indicators of impairment that require an interim goodwill impairment assessment
- The type of events that could lead to a future goodwill impairment

The SEC staff often asks registrants to disclose additional information about their impairment analyses in MD&A after reviewing the supplemental information provided.

Disclosure of accounting estimates
The SEC staff frequently asks registrants to provide more robust disclosures in MD&A about their critical accounting estimates for assessing goodwill for impairment and the details of any recognized goodwill impairments. These requests often focus on:

- The accounting policies relating to the goodwill impairment tests, including when the two-step impairment test is performed, whether the optional qualitative assessment was performed for any reporting units, how reporting units are identified and aggregated and how goodwill is assigned to reporting units
- The facts and circumstances leading to an impairment
- How the fair value of each reporting unit was estimated, including the significant assumptions and estimates used
- Reporting units with material amounts of goodwill that are “at risk”
The SEC staff expects registrants to provide comprehensive disclosures of their critical accounting estimates in MD&A and frequently asks registrants to provide additional information when those MD&A disclosures are not clear.

Qualitative impairment assessment

ASU 2011-08, which was issued in September 2011 and became effective for calendar year-end registrants this year, allows registrants to perform a qualitative assessment to test goodwill for impairment. The ASU does not require any new disclosures, but the adoption of its provisions could result in changes to a registrant’s critical accounting estimates and goodwill impairment testing policy disclosures in MD&A. For this reason, the use of the qualitative assessment may become an area of focus for the SEC staff in the future.

Resources

Financial reporting developments – Intangibles – Goodwill and other
(SCORE No. BB1499), Ernst & Young, August 2012.
Impairment of long-lived assets

Summary of issues noted
The SEC staff focuses on company-specific impairment indicators and frequently asks whether impairment indicators are present that would require registrants to evaluate long-lived assets for impairment. The SEC staff also asks registrants to provide more robust disclosures when a recoverability test is performed and the sum of the undiscounted cash flows does not significantly exceed the carrying value of the assets.

Analysis of current issues
Companies must review long-lived assets that are held and used for impairment when events or changes in circumstances indicate that the carrying amount of the long-lived assets might not be recoverable (i.e., indicators of impairment are present). Companies do not need to routinely perform tests of recoverability but should routinely assess whether impairment indicators are present. ASC 360-10-35-21 provides a list of impairment indicators; however, the listing is not meant to be exhaustive.

The SEC staff’s comments on specific impairment indicators are directed to registrants whose key performance indicators, whether disclosed in their filings or other public information, have trended downward. For example, the SEC staff may question whether an impairment indicator exists when (1) a registrant’s stock price decreases (particularly when market capitalization falls below the carrying amount of the company), (2) its revenue declines, (3) it loses a major customer or contract, (4) it has operating losses or (5) it has idle facilities or equipment.

When any of these factors are present and the registrant did not record an impairment charge, the SEC staff may ask whether the factors were considered to be indicators of impairment that required the registrant to evaluate the long-lived assets for recoverability and, if not, why. If the registrant did not review its long-lived assets for impairment, the SEC staff requests detailed information supporting why such factors were not indicators of impairment.

When the registrant determines that an impairment indicator is present and performs the recoverability test but does not record an impairment, the SEC staff frequently asks for more information about the excess of the undiscounted cash flows over the carrying value of the assets. If the sum of the undiscounted cash flows does not significantly exceed the carrying value of the assets, the SEC staff asks the registrant to provide the following MD&A disclosures:

- A description of the indicators evaluated that led to the need to assess the assets for impairment
- The carrying value of the assets tested
- The percentage by which undiscounted cash flows exceed the carrying value for the most recent recoverability test
- A description of the methods and key assumptions used and how the key assumptions were determined
- A discussion of the degree of uncertainties associated with key assumptions
- A discussion of any potential events, trends or changes in circumstances that could reasonably be expected to negatively affect the key assumptions

The SEC staff may ask whether the registrant considered negative factors identified in the registrant’s filings or other public information to be indicators of impairment and, if not, why.
US GAAP does not specifically require early warning disclosures when impairment indicators exist but no impairment is recorded because the undiscounted cash flows exceed the carrying amount of the assets. However, the risks and uncertainties disclosures in ASC 275-10-50-9 may be required if estimates of future cash flows used in the recoverability test are sensitive to change.

Under ASC 275, if it is reasonably possible that an estimate made as of the balance sheet date will change in the near term due to one or more future events and the effect of the change would be material to the financial statements, the following disclosures are required:

- A description of the nature of the uncertainty
- An indication that it is at least reasonably possible that a change in estimate will occur in the near term

**Resources**

Financial reporting developments – Impairment or disposal of long-lived assets (SCORE No. BB1887), Ernst & Young, Revised October 2011.

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4 The master glossary in the ASC defines near term as “a period of time not to exceed one year from the date of the financial statements.”
Income taxes

Compliance with income tax disclosure requirements

Summary of issues noted
The SEC staff frequently asks registrants whether they have appropriately considered and included all of the disclosures required by ASC 740. In particular, the SEC staff often issues comments when a registrant’s undistributed foreign earnings have been indefinitely reinvested.

Analysis of current issues
The SEC staff expects registrants to provide all of the disclosures required by ASC 740. In particular, the SEC staff issues comments requesting more information about temporary differences for which a deferred tax liability has not been recognized because foreign earnings have been indefinitely reinvested.

ASC 740-30-50-2 requires companies to disclose the amount of the unrecognized deferred tax liability for temporary differences (i.e., outside basis differences where the book basis of the investment exceeds its tax basis) related to investments in foreign subsidiaries and foreign corporate joint ventures that are indefinitely reinvested if determination of that liability is practicable. However, if the determination of that liability is not practicable, a statement that it is not practicable is required.

Resources
Financial reporting developments – Income taxes (SCORE No. BB1150), Ernst & Young, October 2011.

Realizability of deferred tax assets

Summary of issues noted
The SEC staff asks registrants about the realizability of deferred tax assets and the related disclosures both in the financial statements and in MD&A. In particular, the SEC staff often questions the realizability of deferred tax assets recorded by registrants that have recognized consecutive annual losses or a significant loss in the current year. The SEC staff also frequently inquires when a valuation allowance was initially recognized, reversed or significantly changed and the reason for that change is not readily apparent.

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

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

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

- Assessment of all available evidence, both positive and negative, and how the evidence was weighted in determining the realizability of deferred tax assets
Use of similar assumptions and projections of future income to assess the realizability of deferred tax assets and assess long-lived assets for impairment

Deferred tax asset valuation allowance, particularly when either negative evidence suggests it might be necessary or positive evidence suggests it is not necessary

Reversal of a previously recorded valuation allowance when the positive evidence that led to this decision is not readily apparent

Overall, the questions the SEC staff typically raises are the result of what it perceives to be inadequate or overly general disclosures in the financial statements and MD&A regarding how a registrant evaluated the realizability of deferred tax assets.

**Example from SEC comment letter: Realizability of deferred tax assets**

Please tell us the factors that resulted in the significant decrease to the deferred tax asset valuation allowance and how you were able to conclude that it is more likely than not that you will be able to generate sufficient taxable income to realize your deferred tax assets. Please discuss your consideration of all available evidence, both positive and negative, you evaluated.

The SEC staff also questions registrants that appear to arbitrarily limit the number of years considered as projections of future income when assessing the realizability of deferred tax assets.

Further, the SEC staff frequently inquires about the positive and negative evidence that was considered when a valuation allowance was initially recognized, reversed or significantly changed and the reason for that change is not readily apparent. Registrants should carefully assess the realizability of their deferred tax assets and make transparent and complete disclosures in their financial statements and MD&A about a deferred tax asset’s recoverability.

**Resources**

*Financial reporting developments: Income taxes* (SCORE No. BB1150), Ernst & Young, October 2011.
Summary of issues noted

The SEC staff continues to express concern about the transparency of the effect of foreign earnings on a registrant’s effective tax rate.

Analysis of current issues

A registrant may report a relatively low effective tax rate if it derives substantial income from low-tax-rate jurisdictions and indefinitely reinvests such earnings. In these circumstances, the registrant’s income tax reconciliation (ASC 740-10-50-12) may include a large reconciling item related to these low-tax-rate jurisdictions.

The SEC staff often asks registrants that label a reconciling item as the difference between the foreign tax rate and the domestic tax rate whether they actually include more than just the rate differential in that line item (e.g., permanent differences such as tax amortization of foreign entity goodwill). When applicable, registrants should challenge whether this reconciling item should be further disaggregated so that the effect of the low tax rate is presented separately from other items.

Example from SEC comment letter: Foreign earnings

In the rate reconciliation, please describe to us the principal components of the item Tax effect from foreign subsidiaries.

Further, if a disproportionate amount of a registrant’s profit is attributable to countries with low tax rates, such as Ireland, the SEC staff has requested quantified disclosure of such amounts (e.g., $1 billion of our foreign profits were earned in Ireland, which has an effective tax rate of 10%).

The SEC staff also has stated that an investor should be able to easily determine the effective tax rate attributable to a registrant’s domestic and foreign operations. To this end, the SEC staff notes that, in addition to the US GAAP disclosure requirements related to income taxes, Article 4-08(h) of Regulation S-X requires disclosure of the amount of pretax income or loss and income tax expense or benefit generated from domestic and foreign sources.

Resources

Uncertain tax positions

Summary of issues noted
The SEC staff often questions whether registrants have appropriately considered and included all of the uncertain tax position disclosures required by ASC 740. In particular, the SEC staff often comments when those disclosures include proposed adjustments assessed by taxing authorities for significant jurisdictions. The SEC staff asks registrants to explain the potential effect of such adjustments on the financial statements. If the position was previously recognized the SEC staff also questions whether the proposed adjustment is included in the 12-month look-forward disclosure described below.

Analysis of current issues
The SEC staff expects registrants to provide all of the disclosures required by ASC 740 related to uncertain tax positions. Therefore, registrants are encouraged to challenge the completeness of their current disclosures and make any necessary revisions. In summary, the disclosures of uncertain tax positions required by ASC 740 are as follows:

- A tabular rollforward of the beginning and ending aggregate unrecognized tax benefits
- Total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate
- Total amounts of interest and penalties recognized in the financial statements
- Specific detail related to tax uncertainties for which it is reasonably possible the amount of unrecognized tax benefit will significantly increase or decrease within 12 months
- A description of tax years that remain subject to examination for significant jurisdictions
- The policy for classifying interest and penalties

These disclosures are required to be included in a registrant’s annual financial statements. In addition, registrants should disclose any significant changes to these disclosures in their interim financial statements.

Resources
Financial reporting developments – Income taxes (SCORE No. BB1150), Ernst & Young, October 2011.
Summary of issues noted
The SEC staff frequently requests that registrants provide the following information about their intangible-asset disclosures:

- Information about intangible assets recognized as part of a business combination
- Explanation of how the useful lives were determined and the factors leading to the amortization method selected
- Supplemental information on how indefinite-lived intangible assets were assessed for impairment

After reviewing this information, the SEC staff often asks registrants to enhance or revise their intangible-asset disclosures. The new qualitative assessment for testing indefinite-lived intangible assets for impairment allowed under ASU 2012-02 may be an area of focus for SEC staff comments in the future.

Analysis of current issues

Intangible assets recognized in a business combination
ASC 805 requires a registrant to determine the fair value of identifiable assets acquired and liabilities assumed (with certain limited exceptions), including intangible assets that (1) arise from contractual or other legal rights or (2) are separable. The SEC staff frequently challenges whether additional intangible assets should have been recognized in a business combination.

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

The SEC staff also challenges whether registrants have recognized all identifiable intangible assets when other public disclosures or information about an acquisition (e.g., press releases) indicate that there could potentially be value included in goodwill that should be accounted for separately. When the goodwill resulting from a business combination represents a significant portion of the consideration transferred, the SEC staff often challenges whether all identifiable intangible assets acquired were appropriately identified and measured.

The SEC staff may consider all publicly available information (e.g., press releases, presentations) in its evaluation. SEC staff comments request that disclosures be revised to fully explain to investors why the registrant is willing to pay a purchase price that results in a significant amount of goodwill being recognized.

Useful life determination - indefinite-lived intangible assets
When determining the useful life of an intangible asset, a registrant should consider the period over which the asset is expected to contribute directly or indirectly to its future cash flows. Registrants should consider all factors listed in ASC 350 and all...
other relevant information when determining the useful lives of intangible assets. The SEC staff may ask how a registrant has considered its own historical experience in renewing or extending similar arrangements (consistent with the intended use of the asset by the registrant), regardless of whether those arrangements have explicit renewal or extension provisions. A registrant should consider the useful life of an intangible asset to be indefinite only after considering all relevant facts and determining that there are no legal, regulatory, contractual, competitive, economic or other factors that limit the useful life of the intangible asset. The SEC staff routinely challenges assertions that intangible assets have an indefinite life and frequently asks registrants to disclose, when not otherwise provided, what factors were considered in making this determination.

**Example from SEC comment letter: Useful life determination — indefinite-lived intangible assets**

Tell us how you determined that the acquired intangible asset from your acquisition of ABC Company was deemed to have an indefinite useful life. In your response, please tell us why you believe that no legal, regulatory, contractual, competitive, economic, expected use or other factors could limit the useful life of these intangible assets. We refer you to ASC 350-30-35-3.

**Useful life determination and amortization method — customer-related intangibles**

The SEC staff focuses on the useful life and amortization method of acquired finite-lived, customer-related intangible assets (e.g., customer lists, customer contracts, customer relationship intangibles). The SEC staff frequently asks registrants to disclose how they determined the useful life of these assets and challenges such useful lives when the underlying assumptions do not appear consistent with customer information disclosed in other areas of the filing. The SEC staff also often challenges the amortization method chosen for these assets (e.g., straight-line versus accelerated) and requests that registrants explain their key assumptions about the expected future cash flows from an acquired customer-related intangible asset to support their chosen amortization method.

**Example from SEC comment letter: Useful life determination and amortization method — customer-related intangibles**

We note that you assigned $[X] million to your customer relationship intangible asset with amortization periods ranging from 10 to 20 years. Given the wide range in your amortization periods, please tell us how you determined the useful lives of your customer relationship intangible assets, as well as the results of such analysis.
Supplemental information on impairment analysis

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

Qualitative impairment assessment

ASU 2012-02, which was issued in July 2012 and will be effective for calendar year-end registrants next year, gives registrants the option to perform a qualitative assessment to test indefinite-lived intangible assets for impairment. Like the new qualitative assessment for testing goodwill for impairment, the ASU does not require any new disclosures, but the adoption of its provisions could result in changes to a registrant’s critical accounting estimates and indefinite-lived intangible asset impairment testing policy disclosures in MD&A. For this reason, the use of the qualitative assessment may become an area of focus for the SEC staff in the future.

Resources

Financial reporting developments – Intangibles – Goodwill and other (SCORE No. BB1499), Ernst & Young, August 2012.

Financial reporting developments – Business combinations (SCORE No. BB1616), Ernst & Young, September 2011.
Investments in debt and equity securities

Other-than-temporary impairments

Summary of issues noted
The SEC staff asks registrants about the methodology and analysis used to assess whether investments in debt and equity securities are other than temporarily impaired. Further, the SEC staff asks questions about the timing of impairment and changes in circumstances and assumptions to assess whether investors are being provided relevant information about trends and judgments.

Given the current economic conditions in Europe, the SEC staff also has started asking registrants to provide more detailed disclosures about any exposures resulting from investments in securities issued by municipalities or countries experiencing significant economic, fiscal or political challenges.

Analysis of current issues
The SEC staff often challenges whether a registrant’s analysis and methodology is sufficiently robust to evaluate whether an impairment is other than temporary. In some instances, the SEC staff questions a registrant’s analysis that uses arbitrary thresholds (e.g., percentage decline in fair value or specific time period that a security has been in an unrealized loss position). The SEC staff also asks registrants to comply with all of the disclosure requirements for securities accounted for in accordance with ASC 320 (e.g., major security types, cost basis, contractual maturities, methodology and significant inputs used to measure the amount related to credit loss) and other-than-temporary impairment assertions (e.g., the registrant does not intend to sell and it is more likely than not that it will not be required to sell).

Impairment analysis for marketable equity securities
For a marketable equity security, the evaluation of whether an impairment is other than temporary is based on two key assessments. The first is an assessment of whether and when an equity security will recover in value. Factors to consider include the duration and severity of the impairment and the financial condition and near-term prospects of the issuer.

Given continued economic challenges and volatility in the stock market, the SEC staff may ask how a registrant considered the duration and severity of unrealized losses when determining whether an equity security would recover in value and may challenge the weight that a registrant gives to these key factors. In particular, the SEC staff focuses on registrants’ disclosures regarding equity securities in an unrealized loss position for at least 12 months, asserting that the duration of the unrealized loss appears to be a strong indicator that the unrealized losses are not temporary. In these circumstances, the SEC staff asks for a detailed analysis, by issuer, of the extent of the decline, the company-specific facts and circumstances considered in concluding that the unrealized losses were temporary and when the registrant expects the prices to recover.

The second assessment is whether the investor has the positive intent and ability to hold that equity security until the anticipated recovery in value occurs. To support an assertion that an impairment is temporary, the investor should show, with observable market information, that a recovery in the fair value to at least the cost basis of the equity security is expected to occur within a reasonably forecasted
period. That is, the registrant’s ability to hold the equity security until a more favorable market develops and until the issuer-specific uncertainties are resolved is relevant only if persuasive evidence exists that those changes will occur within a reasonable period of time. The SEC staff requests that registrants disclose the specific period of time the registrant considers reasonable when assessing the issuer’s near-term prospects.

**Example from SEC comment letter: Impairment analysis for marketable equity securities**

Please provide us with the following: (1) your definition of reasonable period of time, and note that market price recoveries that cannot reasonably be expected to occur within an acceptable forecast period of time should not be included in the assessment of recoverability and (2) your OTTI analysis of this security at December 31, 2011, and each interim period through June 30, 2012, that identifies the primary objective evidence on which you rely to support a realizable value equal to or greater than the carrying value of the investment.

**Impairment analysis for debt securities**

The SEC staff requests similar information to evaluate whether an impairment in debt securities is other than temporary, but the impairment models for debt differ from the equity models. An impairment of a debt security is considered other than temporary if any of the following conditions exist:

- The investor intends to sell the impaired debt security
- It is more likely than not that the investor will be required to sell the impaired security before recovery in value is anticipated
- The investor does not expect recovery of its entire amortized cost of the security

In instances when the registrant intends to sell an impaired debt security or it is more likely than not that the registrant will be required to sell prior to recovery of its amortized cost basis, an other-than-temporary impairment loss is recognized in earnings equal to the difference between the debt security’s amortized cost basis and its fair value at the balance sheet date. The SEC staff frequently challenges the timing of a registrant’s recognition of an other-than-temporary impairment, focusing on when the decision was made to sell a security. This question typically arises when a registrant discloses that it did not intend to sell a security in an unrealized loss position in one period and then sells that security in a subsequent period.

When a registrant does not intend to sell an impaired debt security and it is not more likely than not that it will be required to sell the security prior to recovery of the amortized cost basis, the registrant must determine whether it will recover the amortized cost basis. If it concludes it will not, a credit loss exists, and the resulting other-than-temporary impairment is separated into the following two amounts:

- The amount representing the credit loss, which is recognized in earnings
- The amount related to all other factors, which is recognized in other comprehensive income
Required disclosures include a discussion of how the amount of the other-than-temporary impairment loss that was recognized in earnings was determined (when an other-than-temporary impairment resulting from other non-credit factors was recognized in other comprehensive income). Additionally, registrants are required to disclose by major security type the method and significant inputs used to measure the amount related to credit losses. Examples of significant inputs the SEC staff expects to see in disclosures about asset-backed securities (including mortgage-backed securities) and collateralized debt obligations include:

- Performance indicators of the assets underlying the security (including default rates, delinquency rates and percentage of nonperforming assets)
- Loan to collateral value ratios
- Third-party guarantees
- Current levels of subordination
- Vintage
- Geographic concentration and credit ratings

In some cases, the SEC staff requests disclosure of the specific collateral underlying each security and detailed information on how the present value of expected cash flows was determined (e.g., discount rate used, how deferral and default estimates are developed, comparison of estimated deferrals and defaults to actual results, recovery rates). In addition, the SEC staff requests that registrants discuss in MD&A trends in cumulative collateral losses and overcollateralization percentages, projected weighted-average loss severity and projected cumulative collateral losses, as well as significant changes in assumptions since the securities were acquired.

Specific investment securities

In certain instances, the SEC staff may ask for detailed information about specific subsets of a registrant's portfolio of investment securities. For example, registrants with significant holdings of securities issued by states, municipalities and political subdivisions may be asked to disclose the following information:

- The amortized cost and fair value of general obligation and special revenue bonds categorized by state, municipality and political subdivision
- The credit rating for such bonds with and without a financial guarantee by third parties
- The amortized cost and fair value of general obligation and special revenue bonds rated investment grade by the credit rating agencies that are trading at credit spreads different from what is expected for the assigned credit rating
- The nature and primary revenue sources for any special revenue bonds
- Procedures for evaluating investments in states, municipalities and political subdivisions (including how the registrant factors in the credit ratings of these securities in its investment analysis and selection process)
In addition, given the evolving European sovereign debt situation, the SEC staff has begun to ask registrants to provide additional details on exposure to Greece and other European countries. The SEC staff has reminded registrants to consider **CF Disclosure Guidance: Topic No. 4: European Sovereign Debt Exposures**, which it issued in January 2012, in determining what information they should disclose about their exposures to countries experiencing significant economic, fiscal or political challenges. The SEC staff also has asked registrants to discuss the effect of the European economic conditions on their pension plan assets.

**Example from SEC comment letter: Specific investment securities**

Please quantify any investments in sovereign and non-sovereign debt in European countries of concern. Please provide this information on a per country basis. To the extent that you have any significant direct or indirect exposures to European debt, please discuss how you are evaluating the risks and uncertainties of these investments. In addition, please discuss if and how you entered into hedging arrangements to mitigate valuation risks.

**Resources**

*Financial reporting developments – Certain investments in debt and equity securities – Accounting Standards Codification 320 (SCORE No. BB0961), Ernst & Young, October 2011.*

*Technical Line – Current economic conditions – financial reporting considerations (SCORE No. BB2170), Ernst & Young, 11 August 2011.*
Summary of issues noted
The SEC staff has increased its focus on nonperformance covenants contained in lease agreements and how these contractual provisions affect the classification of leases.

Analysis of current issues
Some lease arrangements contain default provisions unrelated to the lessee’s use of the underlying asset (i.e., nonperformance covenants). Examples of default provisions are financial covenants that require registrants to maintain certain financial ratios and material adverse change clauses that allow lessors to stipulate remedies based on subjective criteria. The remedies for default might include the right of the lessor to put the underlying asset to the lessee or require a payment to the lessor.

The SEC staff asks both lessees and lessors whether their lease arrangements include these default provisions and if so, how the registrant considered the provisions in its assessment of lease classification.

Example from SEC comment letter: Nonperformance covenants
Please tell us whether your leases contain default covenants related to nonperformance. To the extent that any of your leases contain such covenants, please tell us the specific terms of the covenants, and explain to us how you consider them in the minimum lease payments you use to determine lease classification. Please also tell us whether any of your leases contain material adverse change clauses, cross-default provisions or other subjective default clauses, and explain to us how you consider those provisions in your lease classification analysis.

Under ASC 840, default covenants related to nonperformance do not affect lease classification if certain conditions exist. However, if any of these conditions do not exist, the maximum amount that the lessee could be required to pay under the default covenant should be included in minimum lease payments for purposes of determining lease classification. The probability of the default occurring is not relevant for the classification analysis.

The existence of cross-default provisions in a lease agreement effectively incorporates covenants of other loan or lease agreements into the lease being assessed for classification. Therefore, the maximum amount the lessee could be required to pay under the lease if the cross default were triggered should be included in minimum lease payments for purposes of determining lease classification.

Resources
Financial reporting developments – Lease accounting (SCORE No. BB1793), Ernst & Young, October 2011.
Pension and other postretirement employee benefit plans

Recognition of gains and losses and related non-GAAP disclosures

Summary of issues noted
Non-GAAP disclosures by registrants who have changed their accounting policies to accelerate the recognition of gains and losses in net income have become a recent focus for the SEC staff.

Analysis of current issues
ASC 715 permits net gains or losses on plan assets and the benefit obligation to be included in other comprehensive income in the period in which they arise and subsequently recognized in net income using a minimum amortization approach (i.e., the corridor approach). Gains and losses also may be recognized immediately in net income or on a delayed basis using any systematic method that results in a more rapid recognition of gains and losses than the minimum amortization approach. The determination of which method a registrant uses is an accounting policy election and should be consistently applied.

Recent public comments indicate the SEC staff believes non-GAAP measures that exclude gains and losses from net benefit costs after a registrant changes its accounting policy to accelerate the recognition of gains and losses in net income may be confusing without sufficient context regarding the nature of the adjustment. For example, some registrants may exclude net gains or losses on plan assets from a non-GAAP disclosure about net benefit cost and instead include an expected return. In this instance, the non-GAAP measure may be confusing to investors without adequate disclosure because net benefit cost includes only expected, and not actual, returns on plan assets.

While the SEC staff has not yet asked registrants to remove these non-GAAP measures, the SEC staff has stated that it may comment on non-GAAP disclosures that remove pension-related expenses in the following circumstances:

- Disclosures do not clearly describe what the adjustment represents (e.g., the adjustment removes the amount of actuarial gain/loss immediately recognized in earnings, the adjustment removes all non-service-related pension costs, or the adjustment removes all pension expense in excess of cash contributions).
- Disclosures do not provide quantitative context for the actual and expected returns on plan assets.
- Adjustment is described as “non-cash,” even though the pension liability is ultimately settled in cash, or “non-recurring,” even though the adjustment is reasonably likely to recur within two years or there was a similar adjustment within the prior two years.
- Disclosures do not provide a reasonable basis about why management believes the non-GAAP measure provides useful information to investors.

Resources
2011 SEC annual reports — Form 10-K (SCORE No. CC0337), Ernst & Young, November 2011.

Technical Line – Quicker recognition of postretirement benefit gains and losses (SCORE No. BB2289), Ernst & Young, 17 February 2011.
Summary of issues noted

The SEC staff frequently challenges disclosures about the expected long-term rate of return on plan assets and the assumed discount rate used in estimating defined benefit plan costs and obligations.

Analysis of current issues

The SEC staff often focuses on the expected long-term rate of return and assumed discount rate because some registrants are not providing enough company-specific information in disclosures to help investors understand the judgments they make to arrive at these assumptions.

Expected rate of return on plan assets

Examples of company-specific information used to determine the expected rate of return on plan assets that the SEC staff has requested include:

- A description of the data and the general method used (e.g., arithmetic/simple or geometric/compound averaging) to calculate the expected return
- The categories of investments held as plan assets and a description of investment policies and strategies in the footnotes, with a disclosure in MD&A explaining how the registrant executes its strategy
- An explanation of the effect on the expected return when the registrant changes its plan’s investment portfolio or strategy

When registrants’ expected rate of return assumptions are based on historical returns, the company-specific information the SEC staff requests include:

- Historical and expected rates of return on total plan assets and each major class of plan assets over a long-term market cycle, such as a 10-year period, a 20-year period, or even the life of the plan (if that information is available)
- Whether the long-term expected rate of return on total plan assets represents the historical return by asset class over a long-term market cycle, with explanations for any adjustments made to historical returns to reflect expectations of future returns

Example from SEC comment letter: Expected rate of return on plan assets

Please provide a more company-specific description of the basis used to determine the expected long-term rate of return on assets for your pension plans. For example, disclose the expected rate of return or range for your equity and debt securities. Please also disclose the historical rates of return on assets for the most recent 10-year period and 20-year period on a total asset level and for the two asset allocation categories utilized.
Discount rate

Examples of company-specific information used to determine the assumed discount rate that the SEC staff has requested include:

- Specific source data used to support the discount rate
- A disclosure in the notes to the financial statements or MD&A about how the registrant determined the assumed discount rate (e.g., spot-rate yield curve, a published long-term bond index, annuity rates, a hypothetical bond portfolio)

**Resources**

2011 SEC annual reports – Form 10-K (SCORE No. CC0337), Ernst & Young, November 2011.
Summary of issues noted
The SEC staff often questions how registrants determine whether to present revenue on a gross or net basis. Notably, the SEC staff challenges registrants on their conclusions that net revenue reporting is appropriate nearly as often as it challenges registrants on their conclusions that gross reporting is appropriate.

Analysis of current issues
In many revenue arrangements, a registrant may assist a supplier in the fulfillment of its obligations to deliver goods or services to a customer (e.g., it may ship goods to and bill the customer on behalf of a supplier). In these circumstances, the registrant must determine whether it should report revenue based on (1) the total amount billed to the customer (i.e., gross) because it has earned revenue from the sale of the goods or services or (2) the net amount the registrant retains (i.e., the amount billed to a customer less the amount paid to the supplier) because it has earned a commission or fee. The objective is to determine whether the registrant is in substance acting as the principal that holds substantially all of the risks and benefits related to the sale of a product or service or, alternatively, the registrant is acting as an agent on behalf of another party (e.g., the supplier).

The guidance on principal and agent considerations in ASC 605-45 applies to revenue transactions in all industries unless specific guidance is provided in other authoritative literature. The guidance does not provide any bright lines to determine whether gross or net presentation is appropriate. Rather, it provides indicators suggesting gross or net reporting that often require registrants to apply considerable judgment based on their specific facts and circumstances. No single indicator is presumptive or determinative, and all of the indicators should be analyzed in their totality to determine whether the preponderance of evidence supports gross or net revenue reporting.

Example from SEC comment letter: Gross versus net presentation
We note from your disclosure that you act as a middleman connecting supplier and buyers for your wholesale goods. In addition, it appears from your disclosure that revenue you earn is the difference in the price you pay to suppliers and the price for which you sell to buyers and the product is shipped directly to the buyer by the supplier. Please provide us with a detailed discussion of your revenue recognition under the guidance of FASB ASC 605-45, including your analysis of each of the criteria therein.

Registrants in service and technology industries that do not carry inventory are especially likely to receive questions from the SEC staff about gross versus net determinations.
The SEC staff frequently requests that registrants provide their analyses of each of the indicators identified in ASC 605-45 to support their conclusions on gross or net revenue reporting. Many of these analyses require significant judgment based on the facts and circumstances of a registrant’s arrangement with its supplier(s). It is important that the facts and circumstances considered are complete and consistent with other information that is relevant to the analysis, including what might be found on a registrant’s website. The analysis should be kept up-to-date.

It also is important for registrants to maintain thorough, contemporaneous documentation to support the conclusions made in analyzing these indicators and to perform the analysis for each type of revenue arrangement. It is not uncommon for a registrant to act as a principal in one arrangement, whereby gross revenue presentation is appropriate, while acting as an agent in another arrangement, which would require net revenue reporting. If a registrant has significant operations subject to the guidance in ASC 605-45, it should consider disclosing the various criteria management evaluated in determining whether revenue should be reported gross or net.
Summary of issues noted

The SEC staff requests that registrants expand their accounting policy disclosures on multiple-element arrangements to provide additional information about certain types of contracts or transactions, or to discuss whether the multiple-element arrangements guidance is applicable to their transactions.

Analysis of current issues

Many registrants provide multiple products or services (deliverables) to their customers as part of a single arrangement. These arrangements may range from relatively simple arrangements for the delivery of multiple products on a single date (e.g., when a retailer sells a personal computer and printer to a customer and delivers them together) to more complex arrangements with multiple elements delivered over differing periods (e.g., a vendor provides and installs customized equipment and agrees to run it on an outsourced basis for an extended period).

The revised guidance on accounting for multiple-element arrangements in ASC 605-25 was effective on 1 January 2011 for calendar-year registrants. Following the first year of application of the guidance, the SEC staff is asking about a number of topics addressed by the revised guidance, as discussed below.

Required disclosures

The overall disclosure objective of the revised guidance is to provide qualitative and quantitative information about the significant judgments and changes to those judgments affecting the timing or amount of revenue recognition. The SEC staff frequently requests that registrants expand their disclosures to provide a detailed explanation of how estimated selling price is determined, including a discussion of any factors, trends, inputs, techniques or assumptions used in the registrant’s analysis. Registrants also must disclose how consideration is allocated to the separate units of account within multiple-element arrangements.

Example from SEC comment letter: Required disclosures

Your multiple-elements arrangement disclosure appears to quote accounting literature, but does not provide specific qualitative and quantitative information about your revenue arrangements. Please refer to the guidance in ASC 605-25-50. Provide us with your proposed disclosures.

Registrants should review their disclosures to verify that they not only conform to the specific requirements of ASC 605-25-50-2, but also meet the overall objective discussed above.

Identifying multiple-element arrangements

The multiple-element guidance generally applies to all registrants in all industries. As registrants expand their product and service offerings to meet customer demands, they may combine multiple elements in transactions with customers. The SEC staff requests that registrants provide explanation or further analysis about whether the multiple-element arrangements guidance applies to these transactions. Additionally,
when a registrant discloses it has multiple-element arrangements, the SEC staff asks about specific goods or actions within those arrangements and whether those goods or actions are considered *deliverables* that should be accounted for separately.

**Example from SEC comment letter: Identifying multiple-element arrangements**

Please tell us whether your arrangements contain multiple elements and, if so, how your revenue recognition policy disclosures address these arrangements.

Registrants should ensure that products and services accounted for historically as a single-element arrangement have not become arrangements that include multiple deliverables subject to the guidance in ASC 605-25. Registrants also should consider periodically revisiting their analyses of multiple-element arrangements to determine whether they have appropriately identified the separable deliverables.

**Separation criteria**

The revised multiple-element guidance reduces the number of criteria that must be met to treat deliverables within an arrangement as separate units of accounting by eliminating the requirement for a registrant to demonstrate objective and reliable evidence of fair value of the undelivered item(s). This has generally resulted in more separation of deliverables within an arrangement. One of the criteria that did not change in the revised guidance is that the deliverable must have standalone value.

In recent comments, the SEC staff has requested that registrants provide an analysis supporting their determination that each deliverable accounted for separately has standalone value. However, the SEC staff has not limited its inquiry to those registrants that have concluded standalone value exists. The SEC staff also requests explanations of whether combined elements should be separated because one or more of the deliverables has value to the customer on a standalone basis.

**Example from SEC comment letter: Separation criteria**

Please provide us your analysis demonstrating how each identified unit of accounting had standalone value based on the requirements of ASC 605-25-25-5a. For each deliverable identified as a separate unit of accounting, please state the factors that support or do not support a determination that the deliverable has value to the customer on a standalone basis, and explain the judgment used to reach the final determination.

Registrants should carefully evaluate the criteria for demonstrating standalone value (i.e., the item(s) are sold separately by any vendor or the customer could resell the delivered item(s) on a standalone basis), which could require considerable judgment. Thorough, contemporaneous documentation of that analysis is critical to appropriately applying the separation guidance in ASC 605-25.

**Resources**

Long-term contract revenue disclosures

The SEC staff often requests comprehensive disclosure of the historical precision of estimates associated with long-term contracts.

**Summary of issues noted**
The SEC staff requests that registrants provide additional information in the notes to the financial statements and MD&A when the registrant applies the contract accounting guidance in ASC 605-35. Specifically, the SEC staff asks registrants to disclose more specific information about changes in estimates associated with these arrangements, including the aggregate and per-share effects of any changes in contract estimates.

**Analysis of current issues**
Registrants engaged in contracts to construct tangible assets or to provide services related to the production of tangible assets and certain goods under contract to a customer’s specifications generally apply the revenue recognition guidance in ASC 605-35. This guidance specifies two methods of accounting for contracts within its scope: the percentage-of-completion or the completed-contract method. The method used is based on facts and circumstances and may be challenged by the SEC staff. In applying the percentage-of-completion method, registrants must prepare estimates of the total expected consideration to be received and the total value of the inputs or efforts expended to complete the project. Those estimated amounts are the basis for the amount of revenue recognized for in-progress projects at the balance sheet date.

Although estimating is a continuous and normal process for registrants engaged in long-term contracts, ASC 605-35 requires that significant revisions in estimates be disclosed if the effect is material. Further, ASC 250-10-50 requires disclosure if the effect of the change in estimate is material even though the changes are made in the ordinary course of business. The SEC staff frequently requests that registrants provide additional information about changes in estimates, including quantitative information on the effect of changes in estimates in some instances. Additionally, the SEC staff requests more comprehensive disclosures in MD&A about the registrants’ accounting policy and estimates, such as the methods used by management in forming and updating its estimates and the historical accuracy of those estimates.

**Example from SEC comment letter: Long-term contract revenue disclosures**
Please revise future filings to provide greater insight into the critical accounting estimates related to your revenue recognition. For example, we note your disclosures regarding your recognition of certain contract revenues on the percentage-of-completion method, which is based on contract costs incurred to date compared with total estimated contract costs. Discuss how you develop your estimates of total estimated contract costs. Provide analysis of how accurate your estimates have been in the past, how much the estimates have changed in the past and whether the estimates are reasonably likely to change in the future.

Registrants should consider providing transparent and robust disclosure about their percentage-of-completion accounting policies and any deviations from the basic accounting policies based on the facts and circumstances particular to a specific contract. In particular, registrants should consider providing the disclosures required by ASC 250-10-50 for significant changes in estimate, including revisions to project estimates which are common for contractors.
Segment reporting

**Summary of issues noted**
Segment reporting is a common area of focus in SEC comment letters. The SEC staff focuses its comments on registrants’ conclusions about:

- Identifying operating segments
- Aggregating operating segments
- Providing appropriate entity-wide disclosures with respect to products and services, revenues attributable to individual foreign countries and revenues from major customers

**Analysis of current issues**
The SEC staff routinely expands its review to consider public information available from registrant earnings calls, registrant websites and industry or analyst presentations. The SEC staff asks registrants to explain any perceived inconsistencies between the manner in which the business is described in such public information and their segment footnote. The SEC staff also has requested explanation when inconsistencies exist in how the business is described in the business section and MD&A of a registrant’s public filings and its segment footnote. Addressing the perceived inconsistencies often results in multiple rounds of comments on segment reporting, particularly if the registrant submits a less-than-robust initial response.

**Identification of operating segments**
The segment reporting guidance is conceptually based on a “management approach” (ASC 280-10-5). That is, segment disclosures should be consistent with a registrant’s internal management reporting structure to enable investors to view the registrant similarly to the way management does. Registrants should challenge any conclusions they reach on operating segments that are not consistent with the basic organizational structure of their operations. To support the management approach concept, the SEC staff often requests that registrants include a discussion of their internal structure or an organization chart and examples of resource allocation decisions in their comment letter response.

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 (1) the levels within the registrant at which revenues are earned and expenses are incurred, (2) the registrant’s chief operating decision maker (CODM) and (3) the operating performance information that is available for review by the CODM. For a component to be considered an operating segment, the CODM must have available discrete financial information about the component that is used to assess performance and make resource allocation decisions. The financial information should be sufficiently detailed to allow the CODM to make those decisions.

To evaluate a registrant’s identification of operating segments, the SEC staff requests information that is provided to a registrant’s CODM, board of directors and audit committee. When the CODM regularly receives reports that present discrete operating results for business units of the registrant below the operating segment level identified...
by the registrant, the SEC staff presumes that the CODM uses these reports. The SEC staff frequently challenges registrant assertions that the CODM does not use that financial information to assess performance and make resource allocation decisions. The SEC staff also challenges the appropriateness of the segment profit measure disclosed in a registrant’s segment footnote when the information provided to the CODM includes a different measure of segment profit or multiple measures.

Example from SEC comment letter: Identification of operating segments

Please provide us with representative copies of the reports the Chief Operating Decision Maker (CODM) ... receives and uses in allocating resources and assessing performance.

Identifying operating segments also affects goodwill impairment testing. The SEC staff frequently requests information about the registrant’s determination of its reporting units. Incorrectly identifying operating segments may result in more reporting units and may trigger additional goodwill impairment testing and recognition.

For further discussion on goodwill impairment testing, please refer to the Goodwill section of this publication.

Aggregation of operating segments

ASC 280 allows, but does not require, operating segments to be aggregated for reporting purposes. To be eligible to aggregate operating segments, a registrant must determine whether those operating segments meet certain criteria (ASC 280-10-50-11). There are three key aggregation criteria, all of which must be met and require the use of judgment:

- The aggregation must be consistent with the objective and basic principles of ASC 280.
- The operating segments must be economically similar.
- The operating segments must have similar characteristics.\(^5\)

To be consistent with the objective and basic principles of ASC 280, the aggregation should help users make better-informed judgments about the registrant by improving their understanding of the registrant’s performance and assessment of the prospects for future net cash flows.

ASC 280 requires that aggregated operating segments have “similar economic characteristics,” such that they would be expected to have similar long-term financial performance. The similarity of the economic characteristics should be evaluated based on both current and future projections (ASC 280-10-55-7A). For

\(^{5}\) In addition to being economically similar, operating segments must be similar in all of the following five qualitative areas: (1) nature of the products and services; (2) nature of the production processes; (3) type or class of customer for their products and services; (4) methods used to distribute their products or provide their services and (5) the nature of the regulatory environment, if applicable (ASC 280-10-50-11).
example, if two operating segments (1) have historically had but currently do not have similar gross margins and sales trends, (2) are expected to have similar long-term average gross margins and sales trends in the future and (3) have met the five criteria for having similar characteristics in ASC 280, the two segments may be aggregated. The metrics used in evaluating economic similarity should include those measures used by the CODM in assessing performance and allocating resources and may include others depending on a company’s individual facts and circumstances.

During the comment letter process, the SEC staff may request historical and projected operating margins, gross margins, revenues and other measures of operating performance when challenging the aggregation of operating segments. The SEC staff requests current and projected financial information for operating segments that have been aggregated to support the registrant’s conclusion that such operating segments are economically similar. The SEC staff challenges registrants’ conclusions to aggregate operating segments when current or projected financial information suggests that the operating segments do not have similar economic characteristics and, thus, disaggregated information may be more appropriate. When economic characteristics are dissimilar, the SEC staff presumes that an investor would be interested in separate information about the operating segments.

Further, when operating segments are based on geography and when the relevant macroeconomic indicators have varied or are expected to vary between the respective geographic regions, it might be difficult for a registrant to sustain an assertion that its geographic operating segments exhibit similar long-term financial performance and qualify for aggregation.

*Entity-wide disclosures*

*Disaggregated revenue by product and service*

As part of the entity-wide disclosures, ASC 280 requires a registrant to disclose the amount of revenues derived from transactions with external customers for each product or service or each group of similar products or services, if segments are not reported that way (ASC 280-10-50-40). Entities that have only one reportable segment and that provide a range of products and services also would be required to disclose revenues from transactions with external customers for each product or service or each group of similar products or services. For example, a registrant that sells consumer products and provides services would be required to disclose the revenues from each significant product line or service in its segment disclosure.

During the comment letter process, the SEC staff often requests that registrants that have not disclosed disaggregated revenue information do so or provide an explanation why such disclosure was not necessary. The SEC staff challenges the absence of such disclosure when the registrant’s publicly disclosed information indicates that its reportable segments contain a range of different products or services. The SEC staff also challenges a registrant’s basis for identifying operating segments using something other than its product or service lines (e.g., geography) when the registrant’s publicly disclosed information indicates that management may use financial information by product or service lines to make decisions and allocate resources.
Disaggregated revenue by geography
ASC 280 requires a registrant to disclose certain revenue information attributed to the registrant’s country of domicile and attributed to foreign countries. If material, a registrant also is required to provide the geographic information by individual foreign country (ASC 280-10-50-41(a)).

The SEC staff frequently asks registrants to disclose revenues attributed to specific foreign countries in light of the registrant’s other disclosures about foreign locations.

Revenue contributed by significant customers
ASC 280-10-50-42 requires the disclosure of the total amount of revenues from each major customer (contributing 10% or more of total revenues) and the identity of the segment(s) reporting the revenues.

The SEC staff often requests that registrants disclose such information when other disclosures indicate that there may be a concentration of sales to a particular customer.

Resources
Financial reporting developments – Segment reporting – Accounting Standards Codification 280 (SCORE No. BB0698), Ernst & Young, November 2011.
Share-based payments

Valuation of pre-IPO equity securities

Summary of issues noted
The SEC staff challenges estimates of the fair value of equity securities underlying awards issued in the 12-month period before an IPO when the value is significantly less than the anticipated IPO price.

Analysis of current issues
One of the key accounting issues in many IPO transactions is the valuation of equity securities (including stock options) issued as compensation while a company is privately held. In many cases, IPO prices significantly exceed the estimated fair value of equity securities shortly before the IPO (often referred to as cheap stock because the value of the underlying stock at the date of grant is below the ultimate IPO price). As a result, the SEC staff challenges such valuations and the related disclosures in the financial statements and MD&A.

Example from SEC comment letter: Valuation of pre-IPO equity securities

Discuss each significant factor contributing to the difference between the estimated IPO price and the fair value determined, either contemporaneously or retrospectively, as of the date of each grant and equity-related issuance. This reconciliation should describe significant intervening events within the company and changes in assumptions as well as weighting and selection of valuation methodologies employed that explain the changes in the fair value of your common stock up to the filing of the registration statement.

The SEC staff expects registrants to support judgments and estimates about the fair value of their securities anytime they grant significant share-based payments. The 2004 AICPA Practice Aid, “Valuation of Privately-Held-Company Equity Securities Issued as Compensation” (the Practice Aid), provides a framework for valuation specialists, preparers of financial statements and independent auditors. While the Practice Aid is not authoritative, it provides best practices in the view of the AICPA staff and the AICPA’s Equity Securities Task Force. The SEC staff expects privately held companies contemplating IPOs to apply the Practice Aid’s valuation guidance and recommended disclosures when granting share-based payments.

The Practice Aid recommends that privately held companies obtain contemporaneous valuations from independent valuation specialists to determine the fair value of securities issued as compensation. The Practice Aid asserts that a contemporaneous valuation by an independent party is more objective and provides more persuasive evidence of fair value than a retrospective valuation or one that is performed by a related party (e.g., a director, officer, investor, employee or the investment firm underwriting the IPO). The SEC staff vigorously challenges estimates of the fair value of common stock before the IPO regardless of whether a contemporaneous independent valuation has been obtained. However, the SEC staff is more skeptical of fair value estimates that were not performed by an independent valuation specialist, even when such estimates are higher than a prior independent valuation. Accordingly, a well-documented timeline of significant intervening events (a
summary of which should be disclosed in MD&A), with contemporaneous valuations supporting grants throughout the 12-month period before an IPO, will be important for a registrant to support its judgments and assumptions.

In addition to the guidance included in the Practice Aid, the SEC staff also expects privately held companies to consider other relevant data points when valuing equity securities. For example, privately held companies may sell equity securities to third-parties, or employees may sell shares in secondary markets. The SEC staff expects registrants to provide an analysis of the weightings assigned to third-party private stock sales transactions in each period. Registrants should disclose factors such as the volume of third-party transactions, the timing of transactions and whether the transaction involved investors with access to the registrants’ financial information.

**Resources**

*Financial reporting developments – Share-based payment* (SCORE No. BB1172), Ernst & Young, October 2011.

*Technical Line – Avoiding ‘cheap stock’ issues* (SCORE No. BB2305), Ernst & Young, 9 June 2011.
Subjective valuation assumptions

Summary of issues noted
The SEC staff comments on the quality of disclosures about subjective assumptions used to determine the grant-date fair value of share-based payments. In particular, the SEC staff focuses on disclosure of the expected term and expected volatility assumptions applied in an option pricing model.

Analysis of current issues
Disclosure of assumptions
ASC 718-10-55-21 requires that valuation techniques or models used to estimate the fair value of an employee share option or similar instrument take into account, at a minimum, six inputs. Several of those inputs can be objectively determined (e.g., exercise price, grant-date share price), while determinations of others are subjective (e.g., expected term, expected volatility). ASC 718-10-50-2(f)(2) requires that registrants provide a description of each significant assumption used during the year to estimate the fair value of share-based awards. These disclosures should include the methods for determining expected term and expected volatility, as well as the reasons for any significant changes in assumptions between periods.

Expected term
The expected term of an employee share option or similar instrument is the period of time that the instrument is expected to be outstanding (that is, the period of time from the service inception date to the date of expected exercise or other expected settlement), and it has a significant effect on the option’s fair value. The longer the term, the more time the option holder has to allow the share price to increase without a cash investment and, thus, the more valuable the option. Historical empirical data shows that, for a variety of reasons, employees typically do not wait until the end of the contractual term to exercise an option.

New registrants may not have sufficient historical employee exercise data available to estimate the expected term of employee share options. Other registrants also may, in certain circumstances, have insufficient historical employee exercise data available. In these situations, registrants that have “plain vanilla” options, as defined in SAB Topic 14.D.2, may estimate the expected term assumption using a “simplified” method.

Under the simplified method, the expected term is calculated as the midpoint between the vesting date and the end of the contractual term of the option. The SEC staff does not expect the simplified method to be used when sufficient information about exercise behavior, such as historical exercise data or exercise information from external sources, becomes available. Further, the simplified method is not permitted for options that are not plain vanilla, such as awards granted with an exercise price that does not equal the fair value of the underlying stock on the date of grant, or awards subject to performance or market conditions. The SEC staff questions the use of the simplified method when historical data may appear to be available or the characteristics of the awards are not plain vanilla (e.g., a modified option’s exercise price may be more or less than the share price on the modification date).
Example from SEC comment letter: Expected term

We note from your disclosures that you will continue to use the simplified method to estimate the expected term in your option valuation model until you have enough historical experience to provide a reasonable estimate of expected term. Please explain further why you continue to believe that you do not have sufficient historical data upon which to estimate the expected term of your options.

Registrants that use the simplified method to estimate the expected term of plain vanilla options should clearly disclose in the notes to the financial statements the following:

- Use of the method
- Reason why the method was used
- If the method was not used for all share option grants, the types of share option grants for which the method was used
- If the method was not used in all periods, the periods for which the method was used

Registrants also should consider disclosing that the simplified method was applied only to plain vanilla options.

Expected volatility

Much of the value of a share option is derived from its potential for appreciation. The more volatile the underlying shares, the more valuable the option due to the greater possibility of significant changes in share price. ASC 718-10-55-37 identifies certain factors to consider when estimating expected volatility, including historical volatility and implied volatility (derived from a traded option in the registrant’s shares).

Recent economic uncertainty has affected the operating results and share prices of many publicly traded companies. As a result, registrants currently experiencing higher share price volatility should be considering this increased volatility when evaluating their methods used to estimate expected volatility. In particular, registrants may believe that the method previously used to estimate expected volatility no longer produces the best estimate of expected volatility consistent with the requirements of ASC 718.

The SEC staff asks registrants to provide additional disclosures about the method used to estimate expected volatility. In addition, as a result of the current economic environment, the SEC staff has questioned registrants’ methods for estimating expected volatility when the volatility assumptions they disclose do not change over time.
SAB Topic 14.D.1 provides guidance about the expected volatility assumptions used to estimate the grant date fair value of share-based awards. The SEC staff has indicated that registrants should disclose in their critical accounting estimates and significant accounting policies, if material, the basis for their decisions to use historical volatility, implied volatility or a combination of both. Registrants also should explain the reasons for any change to the method used to estimate expected volatility compared with the prior reporting period as well as the reasons why the volatility assumption has remained constant from period to period (if applicable).

**Resources**

*Financial reporting developments – Share-based payment (SCORE No. BB1172), Ernst & Young, October 2011.*
In this supplement, we analyze trends in SEC staff comment letters related to the automotive industry. These topics should be considered in conjunction with the topics in the main section and other appendices that also may be relevant to registrants in the automotive industry.

**Summary of issues noted**
The SEC staff frequently issues comments to ensure that MD&A is informative and transparent. The SEC staff challenges the sufficiency of disclosures in the automotive industry when registrants discuss the effects of production volume, changes in production mix and government influences on revenues and cost of sales.

**Analysis of current issues**
As discussed in the MD&A section of this publication, the SEC expects management to communicate with investors in a clear and straightforward manner. Management’s discussion of the registrant’s results of operations is a critical component of this communication. Many registrants in the automotive industry provide MD&A about changes in revenues and costs of sales due to global production volatility, changes in production mix and government influences.

When discussing changes in revenues due to shifts in production volumes, registrants should analyze the factors contributing to the changes in volume. It may be appropriate for registrants to provide separate quantitative and qualitative information about the changes in volume attributable to a company’s expansion within growing markets (e.g., Asia) and contraction within declining markets (e.g., Europe). Qualitative and quantitative information also should be disclosed for events that have a direct material effect on production levels (e.g., the flooding in Thailand or the tsunami in Japan). Further, registrants should consider providing industry production levels for the various geographic regions in which they operate in addition to its production volumes within such regions.

When discussing changes in revenues and profit margins due to changes in production mix, registrants should disclose specific trends about product mix and the factors affecting those trends. For example, if a trend is triggering significant revenue growth for products with lower profit margins, the specific trend, as well as the underlying factors affecting this trend, should be discussed and quantified as appropriate.

Automotive companies often receive material economic benefits from national, state and local governments in the US and other regions of the world in the form of incentives designed to encourage automotive manufacturers to establish, maintain or increase investment (e.g., research and development grants, grants or loans from the US Department of Energy). Generally, the expiration without renewal of such benefits could have an adverse effect on the results of operations. Registrants should provide quantitative and qualitative disclosures, if material, of the economic benefits that government incentives have on their results of operations. See the MD&A section of this publication for further discussion.
Summary of issues noted

The SEC staff frequently challenges the accounting for and disclosure of various forms of financial assistance provided by automotive manufacturers to automotive retailers. This assistance can take various forms, but the most common and frequent comments focus on the interest assistance provided by automotive manufacturers to help offset the interest costs incurred by an automotive retailer to finance the purchase of its new vehicle inventory (i.e., floor-plan financing).

Analysis of current issues

Most manufacturers offer interest assistance to automotive retailers to offset floor-plan interest charges incurred in connection with new vehicle inventory purchases. This assistance varies by manufacturer, but generally provides for a defined amount per vehicle purchased, adjusted periodically for changes in market interest rates, regardless of the actual floor-plan interest rate or the length of time for which the new vehicle inventory is financed.

Example from SEC comment letter: Interest assistance

<table>
<thead>
<tr>
<th>Tell us and disclose (1) how the interest assistance is determined and (2) how you are accounting for the interest assistance. Explain to us and disclose how you determined the reduction in cost of sales related to vehicles sold. Lastly, provide us the journal entries to show how you record the interest assistance.</th>
</tr>
</thead>
</table>

ASC 605-50 addresses the accounting for incentives offered by a vendor to any purchasers of its products at any point along the distribution chain, regardless of whether the purchaser receiving the consideration is a direct customer or the customer of a distributor or reseller. ASC 605-50 also addresses the accounting by a customer for cash consideration received from a vendor.

Under ASC 605-50, cash consideration received from a vendor is presumed to be a reduction in the price of products or services acquired from a vendor and should be shown as a reduction of inventory and cost of sales. As a result, automotive retailers should record interest assistance as a reduction to the cost of its new vehicle inventory and a reduction of new vehicle cost of sales as the new vehicles are sold.

The SEC staff often requests that automotive retailers disclose how they account for such interest assistance and any other incentives provided by automotive manufacturers, including the accounting literature they followed, the amounts recognized in the income statement and how those amounts have been recognized in the income statement. The amount of interest assistance recognized is typically a function of: (1) the mix of units being sold since certain automotive manufacturer brands provide more interest assistance than others, (2) the specific terms of the manufacturers' interest assistance programs and market interest rates, (3) the average wholesale price of inventory sold and (4) the rate of inventory turnover.

The SEC staff also may request that automotive retailers discuss the effect of this assistance on their results of operations in MD&A. See the MD&A section of this publication for further discussion.
Appendix A: Industry supplements

Banking supplement

The SEC staff focuses on financial institutions as macroeconomic, geopolitical and regulatory uncertainties continue to affect the banking industry. In this supplement, we analyze trends in SEC staff comment letters related to the banking industry. These topics should be considered in conjunction with the topics in the main section and other appendices that also may be relevant to registrants in the banking industry.

Due to the increased regulation affecting the banking industry, the SEC Division of Corporation Finance split its Financial Services Industry Group in two, creating a group focused on reviewing the largest and riskiest financial institutions on a continuous basis, and a group focused primarily on community and mid-tier banks.

In April 2012, the SEC staff issued disclosure guidance specific to banks, *CF Disclosure Guidance: Topic No. 5 – Staff Observations Regarding Disclosures of Smaller Financial Institutions*6 (CF Topic No. 5). While the guidance is addressed to smaller financial institutions, the SEC staff has said that it should be considered by financial institutions of all sizes.

### Lending activities

#### Allowance for credit losses

**Summary of issues noted**

The SEC staff asks registrants to provide more information about lending activities and the related allowance for credit losses. Allowance policies and procedures, home equity loan portfolios and the use of third-party appraisals are among the SEC staff’s areas of focus.

**Analysis of current issues**

**Allowance policies and procedures**

Given the prolonged economic weakness and continuing pressure on real estate prices, the SEC staff focuses on disclosures in MD&A and the notes to financial statements related to the allowance for credit losses. Specific comments include requests for registrants to provide:

- A prominent discussion of the rationale behind any significant reversals of previously established allowances.
- Discussion of how registrants consider trends in loan write-offs, as well as losses recorded on the subsequent measurement and sale of foreclosed assets, when estimating their allowance for credit losses. The staff is particularly alert when the allowance changes in an opposite direction from key credit metrics.
- Disclosure about how existing macroeconomic factors (e.g., unemployment rates) are considered when adjusting historical loss rates or risk ratings.
- A detailed discussion of the historical accuracy of the general or unallocated portion of the allowance, additional disclosure about the key factors driving the general allowance and quantitative and qualitative discussion of any adjustments to the methodology during the periods presented.

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Registrants should enhance disclosures about significant components of their credit loss estimation methodology and the effect of any changes.

- Enhanced disclosure about the extent to which registrants expect the general allowance to capture distinct risk components (e.g., industry or geographic concentrations, large balance loans, highly leveraged credits, loans originated with policy exceptions).

The SEC staff focuses on the level of detail registrants disclose about important aspects of the methodology they use to estimate the allowance for credit losses. In particular, the SEC staff frequently asks for the following clarifications:

- A registrant's nonaccrual, charge-off and impairment policies, including a description of key differences among different loan products. Policy descriptions should discuss the use of and rationale behind any time-based triggers for nonaccrual and charge-off, as well as any loan-level dollar thresholds for assessing impairment.

- A description of how pool-level allowances are calculated, with particular focus on how management concludes that pools are defined at a sufficient level of granularity so that the loans in the pool exhibit common risk characteristics.

- A detailed discussion of any changes in the methodology used in estimating the allowance for credit losses, including the rationale behind the change and the effect on key metrics such as charge-offs, delinquencies, risk ratings and nonperforming loans.

- A description of new lending programs, including the customers targeted and the typical terms of the loans. The staff also asks financial institutions to describe any risks that are unique to a particular lending program and how those risks are incorporated into the estimate of the allowance for credit losses.

**Example from SEC comment letter: Allowance policy and procedures**

Please tell us and expand your future filings to disclose in greater detail how you consider historical loss experience when collectively evaluating loans for impairment and disclose the historical periods specifically considered in your analysis. Consider providing this information by portfolio segment. In your disclosure, include additional granularity regarding any adjustments made to historical losses and, if applicable, discuss the specific facts and circumstances that provide the basis for such adjustments.

**Home equity loan portfolios**

The SEC staff also expects enhanced disclosures about home equity loans, given the unique risks associated with such loans, including the potential lack of transparency about the performance of the related senior lien loans and the payment terms underlying some home equity loans, such as revolving periods and periods during which non-amortizing payments are made. Enhanced disclosure requests for home equity loans include:

- The typical terms of home equity loans

- Whether the registrant services the first lien loan and, if not, how the registrant monitors the payment status of the first lien and how the potential lack of current first lien delinquency information is considered in estimating any associated allowance for credit losses
How much of the home equity portfolio is amortizing versus non-amortizing, and whether there is a significant difference in performance between amortizing loans and non-amortizing loans

How many borrowers are making only the minimum payment due and how this might affect the allowance

Explanation of any significant differences in delinquency rates and loss rates between first and second lien loans (e.g., second lien loans may exhibit lower delinquency rates but higher loss rates upon default as compared to first lien loans)

Example from SEC comment letter: Home equity loan portfolios

Tell us and revise your future filings to explain how you take into account the lack of available information with respect to the performance of the first lien in your determination of your allowance for loan losses. Tell us and disclose in future filings whether you obtain updated credit bureau data, like refreshed FICO scores, for this portfolio and if so, the frequency that the information is updated. Describe how you consider this information in your allowance for loan losses for your home equity loans that are in the second lien position. Tell us whether you are typically notified by the first lien holder prior to a foreclosure action. In situations where you have been notified that the holder of a superior lien has commenced foreclosure action, tell us how often your second lien position was reflected as current and performing and how and when this information is incorporated into your allowance calculation.

In January 2012, bank regulatory agencies also issued Interagency Guidance on Allowance for Loan and Lease Losses Estimation Practices for Loans and Lines of Credit Secured by Junior Liens on 1-4 Family Residential Properties. That home equity loan guidance is consistent with the comments from the SEC staff.

Use of third-party appraisals

The SEC staff asks registrants to disclose and clarify their policies for measuring impairment of a loan when measurement relies on an estimate of the value of the underlying collateral. Often, the value of collateral is supported by a third-party appraisal. Specific staff comments in this area request that registrants provide more information on the following:

- When and how often third-party appraisals are obtained for measuring impairment based on the collateral value and how this affects the amount and timing of recording loan loss provisions and write-offs
- Whether appraisals are based on “retail” or “as is” values
- How the appraisals are validated and whether (and why) any adjustments are made to the appraiser’s conclusion
- How an institution measures impairment on a collateral-dependent loan when an appraisal is not obtained
Registrants are expected to align their credit quality disclosures with credit quality metrics used by management.

Example from SEC comment letter: Use of third-party appraisals

You indicate that you get updated valuations for non-performing loans on at least an annual basis, and that those valuations are discounted from the most recent appraisal to consider declines in property values. Please provide further details regarding the discounting process used for these older appraisals. For example, tell us if you use a matrix approach and fix the level of discount applied by type of loan and age of appraisal, or whether the analysis is more loan by loan. Tell us what types of procedures you perform to back test or validate that the discount percentages are appropriate.

Credit quality disclosures

Summary of issues noted
The SEC staff often comments on compliance with ASU 2010-20 concerning disclosures on credit quality.

Analysis of current issues
In July 2010, the FASB issued ASU 2010-20 to make reporting about the credit quality of a company’s financing receivables more transparent. Following implementation of ASU 2010-20, the SEC staff has frequently commented on compliance with the disclosure requirements including:

- Disclosure of loan portfolio credit quality based on additional characteristics (e.g., FICO scores, loan-to-value ratios) that may be helpful to users of financial statements
- When a registrant uses an internally assigned risk rating as its credit quality indicator for a class of financing receivables, additional disclosure of the date or range of dates when such risk ratings were most recently updated and a reconciliation of the internal risk rating scale and the risk rating scale used for regulatory purposes

Credit quality indicators disclosed should reflect those used by management to monitor the loan portfolio’s credit risk. For instance, if management updates FICO scores and loan-to-value ratios for a portion of the loan portfolio, the credit quality disclosures should identify which loans were subject to the updates and discuss why those particular loans were updated.

Modifications, including troubled debt restructurings (TDRs)

Summary of issues noted
The SEC staff frequently asks for additional disclosure about the qualitative and quantitative aspects of modification programs.

Analysis of current issues
Given the increase in loan modifications over the last few years, the SEC staff asks financial institutions to enhance their disclosures about loan modification programs, including types of programs used and quantification of modified loans. The SEC staff suggests that companies with significant amounts of modifications consider disclosing:

- A description of the key features of the loan modification programs, including whether the programs are government-sponsored, the significant terms modified and whether the modifications are short- or long-term
Registrants should provide detailed disclosures about loan modification programs, including their impact on credit loss estimates.

- Explanations for modifications that are not being accounted for as TDRs, including the triggers or factors reviewed to identify the loans for modification
- Disclosure of the nonaccrual policy for restructured loans (that are not considered troubled) and the policy’s effects on past due statistics
- A discussion of the registrant’s success with the different types of modifications (e.g., redefault or recidivism rates)
- A description of how TDR volumes and performance rates are considered in the estimate of the allowance for credit losses
- A description of how the company estimates the allowance for credit losses associated with TDRs, with particular emphasis on whether smaller, homogenous loans that are TDRs are reserved for separately from similar loans that are not TDRs
- A rollforward of TDR activity during the period, as well as the company’s accounting policy for determining when it is appropriate to remove a loan’s TDR designation and how the company estimates the allowance for credit losses for such loans when they are no longer considered TDRs

**Example from SEC comment letter: Modifications, including TDRs**

We note you make certain short-term modifications that you do not consider to be TDRs. Please explain to us how you determined that these modifications should not be classified as TDRs. To the extent that you have concluded that the modification results in a delay in payment that is insignificant, please provide a quantitative analysis that supports this conclusion. Please also revise your future filings to provide quantitative information about these modifications.

In April 2012, the Office of the Comptroller of the Currency issued *OCC Bulletin 2012-10: Troubled Debt Restructurings*, which provides regulatory guidance on accounting and reporting requirements for troubled debt restructurings. That guidance is consistent with the SEC staff comments regarding loan modifications.

**Resources**

*Technical Line – New troubled debt restructuring disclosures vary significantly* (SCORE NO. BB2253), Ernst & Young, 4 January 2012.

*Technical Line – New credit quality disclosures – a survey* (SCORE NO. BB2122), Ernst & Young, 26 April 2011.

*To the Point – Creditors may identify more loan modifications as troubled* (SCORE NO. BB2109), Ernst & Young, 5 April 2011.

*2011 SEC annual reports – Form 10-K* (SCORE No. CC0337), Ernst & Young, November 2011.

*Hot Topic – FASB requires new disclosures about financing receivables and the allowance for credit losses* (SCORE No. BB1976), Ernst & Young, 23 July 2010.
Summary of issues noted
In recent years, many banks have acquired other financial institutions that have failed. For registrants that have entered into loss-sharing agreements with the Federal Deposit Insurance Corporation (FDIC) in connection with acquisitions of failed financial institutions, the SEC staff focuses on how they have accounted for and disclosed the loss-sharing agreements. The SEC staff also focuses on the accounting for loans accounted for under the provisions of ASC 310-30.

Analysis of current issues
The SEC staff requests that registrants comply with all required loan disclosures for acquired loans, regardless of whether the loans are covered by a loss-sharing agreement.

The SEC staff has indicated that the assets covered by loss-sharing agreements should be recorded in the respective balance sheet categories (e.g., loans, other real estate owned). The SEC staff has indicated that it is acceptable to segregate (e.g., use a separate subheading) assets covered by and those not covered by loss-sharing agreements.

The SEC staff expects a loss-sharing agreement to be presented as a separate asset on the balance sheet rather than included with the indemnified items. The SEC staff also requests that the registrant provide a rollforward of the indemnification asset, which would include increases attributable to credit deterioration in the underlying assets, cash collected and income accreted. The SEC staff also requests similar detail related to any associated clawback liabilities.

Many of the loans subject to loss-sharing agreements with the FDIC are accounted for as purchased credit impaired loans in the scope of ASC 310-30 or by analogy to that guidance. The SEC staff focuses on the following disclosures about the accounting for and disclosures involving these loans:

- Disclosure of which loans are within the scope of ASC 310-30 and those loans where ASC 310-30 is applied by analogy
- A description of what common risk characteristics are used to aggregate loans into pools
- A rollforward of the loans accounted for under ASC 310-30, as well as a rollforward of the associated accretable yield and an explanation for any significant changes to the assumptions underlying the estimate of accretable yield
- A reconciliation between the carrying amount of the loans and the contractual amounts due

Example from SEC comment letter: Accounting for purchased credit impaired loans
Please provide us with a rollforward of your loans accounted for under ASC 310-30 which reconciles your contractual receivable to your carrying amount. Your revised disclosure should also include disaggregated information pertaining to your nonaccretable yield.
Summary of issues noted

The SEC staff often comments on the disclosure requirements for mortgage and foreclosure-related activities.

Analysis of current issues

In October 2010, the SEC staff issued a “Dear CFO” letter with accounting and disclosure considerations related to potential risks and costs associated with mortgage and foreclosure-related activities. In that letter, the SEC staff suggested disclosures to consider and provided reminders about existing requirements, including:

- The implications of various representations and warranties made to purchasers of mortgages
- Known trends, demands, commitments, events or uncertainties that the registrant reasonably expects to have a material effect on the registrant (e.g., suspending foreclosure pending further review)
- Disclosures of litigation and other contingencies, including accruals
- Quantitative and qualitative discussion of the reasonably possible outcome of litigation and other contingencies
- A rollforward, if applicable, of the activity in a registrant’s reserve relating to representations and warranties attributable to sold loans
- A description of the process for estimating indemnification reserves, including the methodology, assumptions and events (e.g., increase in repurchase requests) that trigger a change in reserves
- The time period permitted to respond to an indemnification request and the consequences of a non-timely response
- Unresolved claims and rejected claims, disaggregated by claimant or claimant type
- Delinquency and other information about loans covered by indemnification agreements that may be relevant to possible future indemnification demands
- If applicable, an affirmative statement that the registrant does not have complete information about the underlying credit performance of loans that it does not service
- Actions taken related to indemnification claims for which the registrant has recourse to the seller or broker and how the results of those actions are factored into estimating the reserves

In subsequent reviews, the SEC staff has focused on whether its suggestions have been implemented.

For companies with mortgage servicing rights (MSRs), the SEC staff asks for more disclosure about the changes in fair value, particularly with respect to identifying and discussing which primary assumptions were the key drivers of the change in value. The SEC staff also asks that registrants consider disclosing valuation inputs for its MSRs at a greater level of disaggregation (i.e., tranche-level detail).

Summary of issues noted

The SEC staff focuses on industry-specific issues related to a financial institution’s assessment of impairment of goodwill.

Analysis of current issues

Some financial institutions use an economic capital model to allocate net carrying value to various reporting units for purposes of analyzing whether goodwill is impaired. The SEC staff requests clarification of financial institutions’ capital allocation methodologies, specifically asking for the following:

- A detailed description of how economic capital is determined, including how the allocation of economic capital is reviewed and approved and whether the allocation is reviewed by the registrant’s board of directors and bank regulators
- If segment disclosures show that the total equity assigned to reportable segments is not equal to the consolidated registrant’s total equity, a clarification whether the equity assigned to reportable segments also is used for goodwill impairment testing and, if so:
  - A reconciliation of differences between total equity and allocated capital
  - A more detailed description of the registrant’s policy for assessing goodwill impairment, including an explanation of how the registrant determines that any excess capital is not allocable to specific reporting units, including the identification of the assets and liabilities that management determines are not allocable to specific reporting units

When financial institutions change their capital allocation method to an economic capital method, the SEC staff requests a reconciliation or explanation of any resulting changes in the amount of equity attributed to a reportable segment.

Example from SEC comment letter: Goodwill impairment considerations

We note your disclosure that the carrying amount of a reporting unit is determined based on the capital required to support the reporting unit’s activities, including its tangible and intangible assets. You also state that the determination of the reporting units’ capital allocation requires management judgment and considers many factors, including the regulatory capital regulations and capital characteristics of comparable public companies in relevant industry sectors. Clarify in further detail the capital allocation methodology used to determine the carrying value of your reporting units. To the extent the total capital required to support the reporting unit’s activities is more or less than the total shareholder’s equity of the company, please tell us how you account for any difference.

For further discussion on goodwill impairment testing, please refer to the Goodwill section of this publication.
Additional areas of focus

Summary of issues noted

In CF Topic No. 5, the SEC staff highlights other key areas not discussed above. These areas include the following:

- Commercial real estate loans – The SEC staff may ask a registrant to explain the effect of collateral value on its conclusion whether a commercial real estate loan is impaired, how collateral values are monitored and evaluated in estimating the allowance and the reasons behind any trends in collateral values.

- Other real estate owned (OREO) – Given the increased volume of foreclosures in recent years, the SEC staff also focuses on enhanced disclosures relating to a registrant’s OREO balance. Additional disclosures requested might include the balance of OREO by type of asset, a rollforward of the OREO balance and a description of recent OREO sales experience compared to recorded amounts. The SEC staff also may ask about the magnitude of write-downs taken on assets classified as OREO. See the Nonrecurring fair value measurements discussion in the Fair value measurements section of this publication.

Resources

Technical Line – New credit quality disclosures – a survey (SCORE NO. BB2122), Ernst & Young, 26 April 2011.

Hot Topic – FASB requires new disclosures about financing receivables and the allowance for credit losses (SCORE No. BB1976), Ernst & Young, 23 July 2010.
In this supplement, we analyze trends in SEC staff comment letters related to the insurance industry. These topics should be considered in conjunction with the topics in the main section and other appendices that also may be relevant to registrants in the insurance industry.

**Summary of issues noted**

The SEC staff issues comments aimed at improving the quality and usefulness of disclosures about property and casualty loss and loss adjustment expense reserves. The SEC staff frequently requests that registrants provide more information about the process they use to develop the estimate, any changes in this process and information about why the change in estimate occurred in the current period and not a previous period. The SEC staff also asks for more detail about the key assumptions used by management.

**Analysis of current issues**

The SEC staff comments address property and casualty loss and loss adjustment expense reserves in the critical accounting estimates section of MD&A, in the significant accounting policies footnote and in a registrant’s loss reserve rollforward disclosures. MD&A typically includes disclosure about the methods used to estimate property and casualty loss reserves and changes in reserve estimates. These disclosures tend to provide general information about reserve development involving severity trends, reserve releases or strengthening.

The SEC staff requests that registrants disclose more specific information about changes in reserve estimates, both favorable and unfavorable, including identifying factors that caused actual experience to differ from what was expected and whether current trends are expected to continue. The SEC staff has specifically requested that registrants disclose within the notes to the financial statements how management determined that the period in which the reserve change was recognized is appropriate and why recognition was not required earlier.

In addition, the SEC staff asks registrants to provide more detail about the key assumptions used by management, the variability in the key assumptions and the effect on the financial statements if there were changes in those assumptions. For example, the SEC staff requests that registrants provide quantitative information in MD&A about reasonably likely future changes in key assumptions.

For further discussion about critical accounting estimate disclosures, please refer to the MD&A section of this publication.

**Example from SEC comment letter: Property and casualty loss reserves**

Provide us proposed disclosure that clearly explains why recognition occurred in the period that it did and why recognition was not required in earlier periods. Provide disclosure to be included in future periods that quantify the frequency and severity trends that led to changes in the estimate.

**Resources**

*2011 SEC annual reports – Form 10-K (SCORE No. CC0337), Ernst & Young, November 2011.*
Reinsurance agreements

Summary of issues noted
The SEC staff often questions the accounting and disclosure of reinsurance agreements, focusing on disclosure of the key terms of the agreements, the effect of the agreements on the current-period financial statements and on future operating results, as well as the effect on registrants’ effective tax rates.

Analysis of current issues
Entering into a new reinsurance agreement can significantly affect the financial statements and tax liabilities of insurers; however, the effects of these agreements are not always explicitly disclosed in the financial statements. The SEC staff frequently comments when, in its view, there is a disproportionate relationship between US premiums written and pretax income of an insurer. The SEC staff has asked multinational insurers to explain the underlying reasons for variances in this ratio.

Registrants should consider whether they are disclosing the material effects of all reinsurance agreements in their filings, either in MD&A or the financial statements. Disclosures should include the current-period effect of the agreements (in MD&A or financial statements) and the likely effects on future operating results (in MD&A).

When registrants have significant reinsurance recoverables, the SEC staff requests disclosure of the parties to the reinsurance contract and the key terms of the agreement. The SEC staff reminds registrants that any material reinsurance agreements are required to be filed as exhibits to Form 10-K or 10-Q in the period they are executed.

Example from SEC comment letter: Reinsurance agreements
For any material reinsurance transactions please provide a discussion of the underlying business ceded, material terms of the transaction, the extent to which future recoverables could increase under the agreements and the Company’s potential liabilities in the event reinsurers do not meet their obligations.
In this supplement, we analyze trends in SEC staff comment letters related to the life sciences industry. These topics should be considered in conjunction with the topics in the main section and other appendices that also may be relevant to registrants in the life sciences industry.

**Revenue recognition**

**Revenue deductions**

**Summary of issues noted**

For life sciences registrants, revenue recognition is a principal area of focus by the SEC staff, which often challenges their ability to make reasonable estimates of product returns and to demonstrate how selling prices are fixed or determinable in light of new or novel product offerings. In addition, the SEC staff requests that registrants provide enhanced disclosure about items that reduce gross revenue (e.g., estimates of product returns, rebates, distributor chargebacks and distributor incentives) in their results of operations and critical accounting estimates sections of MD&A.

**Analysis of current issues**

**New product offerings**

Registrants in the life sciences industry commonly offer customers rights of return or provide rebates, chargebacks or other incentives. Registrants must determine whether selling prices are fixed or determinable in order to recognize revenue upon delivery of products to customers. For fees to be fixed or determinable, registrants must be able to reasonably estimate rebates, chargebacks and other incentives as well as the amount of future product returns.

The SEC staff challenges a registrant’s ability to make reasonable estimates when it has recognized revenue for the sale of a new, novel or unique product. As part of its review process, the SEC staff may point to information in the registrant’s Form 10-K and 10-Q filings, recent press releases, marketing materials or recent management presentations that indicate a product is new, novel or unique in some respect. The SEC staff may request that registrants explain how they determined their estimates of product returns, rebates, chargebacks and other incentives in the absence of historical information related to a new product. Based on this information, the SEC staff may request that registrants expand their MD&A and critical accounting estimates disclosures.

**Disclosures**

Often the judgments and assumptions registrants make when they estimate revenue deductions (e.g., product returns, rebates, chargebacks) have a material effect on their reported financial condition and operating performance and on the comparability of that information among reporting periods. The SEC staff often asks registrants to provide more robust disclosures, including the following:

- Expanded disclosure about the nature and amount of each revenue deduction, along with information about the key terms of material arrangements or agreements that influence the estimate of each deduction as of each balance sheet date
• Rollforward information for each revenue deduction for each financial statement period presented, including the beginning and ending accrual balances, the current provision related to sales made in the current and prior periods (presented separately) and the actual returns or credits in the current period related to sales made in the current and prior periods (presented separately)

• Additional disclosure of the qualitative factors that management considers when estimating each revenue deduction, including the following:
  • How management evaluates factors such as levels of inventory in distribution channels, estimated remaining product shelf lives, shipments of product made as a result of incentives, shipments in excess of the customers’ ordinary demand and introductions of new or generic competitive products
  • The extent, availability and use of information from external sources, such as end-customer prescription data from third parties, distributor inventory reports and third-party market research data comparing wholesaler inventory levels to end-customer demand
  • Quantitative information to support qualitative factors a registrant considers when estimating each revenue deduction, such as detailed quantitative information by product, including the total amount of product sales that could potentially be returned as of the most recent balance sheet date, disaggregated by expiration period, if any
  • The effects that could result from using other reasonably likely assumptions to estimate each revenue deduction, as well as a range of reasonably likely estimates or other type of sensitivity analyses
  • The underlying business reasons for material period-to-period fluctuations in each type of reduction of gross revenue, including the effect that changes in estimates have on revenues and obligations

Milestone method of revenue recognition

Summary of issues noted
The SEC staff frequently asks life sciences registrants to expand disclosures for each research and development arrangement for which they recognize revenue from one or more milestone payments in accordance with ASC 605-28.
Analysis of current issues

Life sciences registrants often enter into arrangements to provide research or development deliverables in which one or more payments are contingent upon achieving uncertain future events or conditions called milestones. Life sciences registrants may elect to recognize revenue upon achievement of a milestone in its entirety in the period in which the milestone is achieved if the milestone meets all criteria to be considered substantive in ASC 605-28-25-2. The SEC staff requests that life sciences registrants provide explanation or further analysis about how recognized milestones meet the criteria to be considered substantive.

Example from SEC comment letter: Milestone method of revenue recognition

Please tell us how your accounting for milestone payments complies with the three criteria in ASC 605-28-25-2.

If the milestone method is elected and arrangement milestones meet the criteria to be considered substantive, registrants must provide the following additional disclosures about the research or development arrangements with milestone payments:

- A description of the overall arrangement
- A description of each milestone and related contingent consideration
- A determination of whether each milestone is considered substantive
- The factors that the registrant considered in determining whether milestones are substantive
- The amount of consideration recognized during the period for those milestones

ASC 605-28-50-2 requires disclosures at the individual milestone level. As a result, the SEC staff questions the adequacy of disclosures for each arrangement and each milestone. Many registrants, especially those with multiple arrangements and numerous milestones within each arrangement, may prefer to include disclosures on an aggregated basis in an effort to improve their usefulness. While SEC staff comments and responses indicate it believes disclosure of each milestone is required, in certain cases, it has not objected to aggregated disclosures. When the SEC staff has not objected to aggregation, registrants have asserted that individual milestones are not material and information on an aggregated basis would be more useful to users of financial statements.

Resources

Technical Line – Aggregating milestone method disclosures may sometimes be appropriate (SCORE No. BB2264), Ernst & Young, 12 January 2012.
Multiple-element arrangements

Summary of issues noted

The SEC staff asks registrants to expand their accounting policy disclosures about multiple-element arrangements. Specifically, the SEC staff requests that registrants disclose all of the information required by ASC 605-25-50-2.

Analysis of current issues

Required disclosures

Registrants in the life sciences industry often enter into arrangements with counterparties that include multiple elements, such as licensing intellectual property, research and development services, manufacturing services and commercialization activities. Consideration received under these arrangements can be significant and is often the primary source of revenue for life sciences registrants without commercial products of their own.

Because of the unique nature of the products and services underlying these arrangements, the significance of the consideration transferred and the level of judgment involved in determining the appropriate accounting, the SEC staff frequently requests that registrants in the life sciences industry expand their disclosures about multiple-element arrangements. Life sciences registrants should review their disclosures to verify that they provide both quantitative and qualitative information about significant judgments they make (and changes in those judgments) in applying the multiple-element guidance and that they comply with the specific requirements of ASC 605-25-50-2.

Identifying multiple-element arrangements

The SEC staff often requests that life sciences registrants provide explanation or further analysis about specific items in a transaction and whether those items are considered deliverables that should be accounted for separately. For example, the SEC staff has requested additional analysis about the following:

- Transfer of a license to a product candidate
- Research and development services
- Manufacturing and supply agreements
- Participation in joint steering or development committees

Example from SEC comment letter: Identifying multiple-element arrangements

In your evaluation of deliverables, how did you consider the obligations of each of your committees (i.e., joint steering committee and joint development committee)? Are these obligations considered a deliverable? Why or why not?
The SEC staff may request an evaluation of standalone value for each deliverable.

**Separation criteria**

The revised multiple-element guidance reduced the number of criteria that must be met to treat deliverables in an arrangement as separate units of accounting. This generally has allowed life sciences registrants to more easily separate the deliverables in an arrangement (e.g., license of product compound and research and development services). In its recent comments, the SEC staff has focused on the remaining separation criteria by requesting an evaluation of standalone value for each deliverable a registrant accounts for separately. However, the SEC staff has not limited its inquiry to registrants that have concluded standalone value exists, which generally allows them to recognize revenue earlier for delivered elements. The SEC staff also challenges whether combined elements should be separated because one or more deliverables have value to the customer on a standalone basis.

**Example from SEC comment letter: Separation criteria**

You indicate you believe the license of Product X and the related research and development services to be separate units of accounting. Please provide us your analysis demonstrating how each unit of accounting had standalone value based on the requirements of ASC 605-25-25-5a (i.e., sold separately by any vendor or the customer could resell the unit of accounting on a standalone basis).

For further discussion, please refer to the *Multiple-element arrangements* discussion in the *Revenue recognition* section of this publication.

**Resources**


**Summary of issues noted**

Given the current economic conditions in Europe, the SEC staff is asking registrants in the life sciences industry to provide more detailed disclosures about receivables from and the amount of product sales by country, particularly those European countries currently experiencing economic challenges.

**Analysis of current issues**

The SEC staff questions registrants’ exposures to government-owned or -supported customers. When registrants have past due receivables from product sales to government-owned or -supported customers in certain European countries, the SEC staff has requested the following information:

- Amount of product sales by country
- Accounts receivable outstanding by country separated by amounts due directly from the government or funded by the government and amounts due from other parties
Appendix A: Industry supplements

The SEC staff requests more detailed disclosures about receivables from countries experiencing economic challenges.

**Collaboration arrangement disclosures**

- Amount of past due accounts receivable by country and number of days past due separated by amounts due from the government or funded by the government and amounts due from other parties
- Amount of allowance for doubtful accounts by country
- The basis for the conclusion that the allowance adequately addresses the collectibility of current and past-due receivables for these customers

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<th>Example from SEC comment letter: Accounts receivables from European entities</th>
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<td>Please provide us proposed disclosure to be included in future periodic reports that breaks out the amount of trade receivables from product sales and the amount of product sales by country in Italy and Spain (and Greece and Portugal, if any) and also disclose the amounts that are past due from each of these countries separately. Disclose the portion in each of these countries that is due directly from the government or funded by the government.</td>
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For further discussion, please refer to the Accounts receivable from European entities discussion in the Accounts receivable section of this publication.

**Summary of issues noted**

The SEC staff frequently requests that registrants expand their disclosures about collaboration arrangements to include a discussion of the overall nature of the arrangement, the amounts and factors affecting payments the registrant may receive or be required to make under the arrangement (e.g., milestone or royalty payments) and the accounting policy for recognizing amounts received or paid. Further, when considered significant, the SEC staff requests that registrants file such an agreement as an exhibit to the SEC filing or, alternatively, provide an analysis supporting the determination that the agreement is not required to be filed as an exhibit under Item 601 of Regulation S-K.

**Analysis of current issues**

**Disclosures**

Financial statement disclosures for each individually significant collaboration arrangement should include information about the nature and purpose of the collaboration arrangement, a description of the deliverables under the arrangement, the accounting policy for recognizing payments received under the arrangement and a discussion of the material terms of the arrangement (e.g., rights and obligations, performance, cancellation, termination or refund provisions). Disclosures should clearly describe any payment obligations under collaboration arrangements and the registrant’s accounting policy with respect to those items, as well as the income statement presentation and amounts attributable to collaboration arrangements for each applicable period.
The SEC staff has indicated that registrants should consider disclosing the following specific items related to collaboration arrangements:

- The identity of the other party in the arrangement
- The products being developed, as applicable
- Any amounts paid or received to date under the arrangement (including up-front licensing fees and milestone payments)
- Under each arrangement, aggregate potential milestone payments to be made or received and the triggering events underlying the milestones
- The existence of royalty provisions, rates (or ranges within defined percentages if tiered) and any sales thresholds related to royalty rates
- Annual maintenance fees
- Duration and termination provisions, including payments the registrant may be required to make in the event of termination

For registrants with payment obligations under collaboration arrangements, the SEC staff has indicated that potential payments should be included within the contractual obligations table in MD&A if their occurrence is reasonably possible. If potential payments are not reasonably possible, the SEC staff has requested disclosure of the reason(s) for excluding such payments from the table. See the “Liquidity and capital resources” section of this publication for further discussion of the contractual obligations table.

If registrants don’t disclose certain aspects of collaboration arrangements (e.g., specific royalty rates or the possibility that milestones might be achieved) due to concerns about confidentiality, the SEC staff generally challenges whether such disclosures should be provided. The SEC staff often challenges whether confidentiality concerns outweigh the needs of financial statement users.

Exhibits

Item 601 of Regulation S-K contains instructions for the filing of exhibits and identifies the exhibits to be included in each SEC filing. Item 601(b)(10)(ii)(B) requires that certain contracts entered into in the ordinary course of business be filed as exhibits if the registrant’s business is “substantially dependent” on the contract (e.g., sales contracts with significant customers, contracts with suppliers for significant components of a registrant’s products or services or other agreements to use, license or franchise a patent, formula, trade secret, process or trade name upon which a registrant’s business depends to a material extent).

When disclosures in other parts of an SEC filing indicate a collaboration arrangement is significant absent a filed exhibit, the SEC staff asks the registrant to explain why it is not “substantially dependent” on the arrangement. This determination is generally qualitative, and registrants should consider all relevant facts and circumstances, including:

- Whether the registrant’s future success depends on a successful development outcome for items covered by the arrangement
The existence of other counterparties that would be able to fulfill the obligations required under the arrangement

The existence of collaborative arrangements related to the registrant’s other development projects

The significance of the R&D arrangement to the overall development project

Resources
2011 SEC annual reports — Form 10-K (SCORE No. CC0337), Ernst & Young, November 2011.

Summary of issues noted
The SEC staff often challenges registrants’ identification and valuation of in-process research and development (IPR&D) projects. The SEC staff requests additional information and disclosures about IPR&D assets acquired in business combinations.

Analysis of current issues
Intangible assets acquired in business combinations that are used in research and development activities (i.e., acquired IPR&D assets) are initially recognized as assets at fair value, regardless of whether the acquired assets have an alternative future use. These assets are classified as indefinite-lived assets until completion or abandonment.

When registrants have recently completed business combinations, the SEC staff requests that they provide additional information to the SEC staff and, in some cases, provide additional disclosures about the acquired IPR&D assets. Registrants may be asked to explain how IPR&D assets were recognized or why, based upon other information disclosed, no or limited IPR&D assets were recorded.

The SEC staff also requests that registrants continue to provide the disclosures included in the AICPA’s Technical Practice Aid, Assets Acquired in a Business Combination to Be Used in Research and Development Activities: A Focus on Software, Electronic Devices and Pharmaceutical Industries (the TPA). The TPA identifies best practices related to defining, valuing, accounting for, disclosing and auditing IPR&D assets acquired in business combinations. Although the TPA is not authoritative GAAP, there is little other guidance on the measurement and disclosure of IPR&D assets.

The TPA includes the following suggested financial statement and MD&A disclosures:

- Specific nature and fair value of each significant IPR&D project acquired
- Completeness, complexity and uniqueness of the projects at the acquisition date
- Nature, timing and estimated costs of the efforts necessary to complete the projects and the anticipated completion dates
- Risks and uncertainties associated with completing development on schedule and consequences if not completed timely

8 ASC Topic 805 and ASC Topic 820 supersede certain aspects of the recognition and measurement guidance included in the TPA. At the time of publication of this document, the TPA has not been updated. Until the TPA is updated, the guidance included therein that conflicts with ASC 805 and ASC 820 should not be considered in the accounting for acquired IPR&D assets.
Disclosures related to material patents

The SEC staff requests that registrants disclose the nature of material pending patents.

Resources

Financial reporting developments – Business combinations (SCORE No. BB1616), Ernst & Young, September 2011.

Summary of issues noted

The SEC staff frequently requests that registrants in the life sciences industry revise or expand their MD&A to discuss all material patents. The SEC staff frequently challenges the adequacy of disclosures relating to patents and may request additional information about each patent that is owned, licensed or pending.

Analysis of current issues

Most registrants in the life sciences industry own, license or have applied for a large number of patents in the US and many other countries relating to products, product uses, formulations and manufacturing processes. The SEC staff requests that registrants in the life sciences industry that own or license a large number of patents provide additional disclosures about the nature of those patents. Specifically, the SEC staff frequently asks registrants to provide the following disclosures for material patents:

- A discussion of the products or technologies that relate to the patent
- The jurisdiction in which the patent is granted
- The expiration date
- Patents subject to legal proceedings
- Whether the patents are owned or licensed

The SEC staff requests that registrants with multiple patents for a product or technology disclose the above information by patent, or identify individual patents that have been aggregated for disclosure based on similar characteristics. In addition, the SEC staff requests that registrants disclose the nature of material pending patents, including a discussion of the products or technologies that relate to the pending patent and the jurisdiction in which the patent was requested.

Resources

2011 SEC annual reports – Form 10-K (SCORE No. CC0337), Ernst & Young, November 2011.
Summary of issues noted

The SEC staff frequently asks registrants in the life sciences industry to provide more detailed disclosures in MD&A about their R&D activities. Specifically, the SEC staff focuses on the status of major R&D projects and the costs incurred to date as well as the estimated completion dates, completion costs and capital requirements.

Analysis of current issues

Most registrants in the life sciences industry incur significant expense for R&D activities and, for some, this may be the single largest expense on the income statement.

If R&D expense is significant, the SEC staff often asks registrants to provide more specific MD&A disclosures, including:

- The nature, objective and current status of each project and the extent to which its success depends on parties other than the registrant
- The costs incurred during each period presented and to date on each project
- The nature, timing and estimated costs of the efforts necessary to complete each project
- The anticipated completion dates of each project
- The risks and uncertainties associated with completing development on schedule, and the consequences to operations, financial position and liquidity if each project is not completed timely
- The period in which material net cash inflows from each significant project are expected to begin
- The criteria used for identifying a project as significant
- For projects determined not to be individually significant, the number of programs and cost for each period by therapeutic category, or other descriptive class or category, and an estimate of the nature, timing and expected costs to complete

The SEC staff requests that a registrant that does not track R&D costs by project disclose that fact along with an explanation of why that is the case. In these situations, the SEC staff also requests other quantitative or qualitative disclosures that describe the amount of the registrant’s resources being used on each project or group of projects (e.g., by therapeutic class). If registrants conclude they are unable to track R&D costs in any way other than by total R&D expense, the SEC staff requests that registrants disclose that fact. Similarly, if registrants cannot estimate the completion dates or costs to complete the projects, the SEC staff asks registrants to disclose the circumstances or uncertainties precluding such estimates.
<table>
<thead>
<tr>
<th>Example from SEC comment letter: Research and development expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td>In order to gain a better understanding of the effects and expected effects of your research and development activities on results of operations and financial position, please provide us, as practicable, the following additional information: For significant products in research and development:</td>
</tr>
<tr>
<td>- The costs incurred during each period presented. If you do not maintain any research and development costs by project, provide us other quantitative or qualitative disclosure that indicates the amount of the company’s resources being used on the project</td>
</tr>
<tr>
<td>- The nature of efforts and steps necessary to complete the product</td>
</tr>
<tr>
<td>- The risks and uncertainties associated with completing development and the extent and nature of additional resources that need to be obtained if current liquidity is not expected to be sufficient to complete the product</td>
</tr>
</tbody>
</table>

For further discussion, please refer to the MD&A section of this publication.

**Resources**

*2011 SEC annual reports – Form 10-K (SCORE No. CC0337), Ernst & Young, November 2011.*
In this supplement, we analyze trends in SEC staff comment letters related to the media and entertainment industry. These topics should be considered in conjunction with the topics in the main section and other appendices that also may be relevant to registrants in the media and entertainment industry.

**Summary of issues noted**

The SEC staff frequently requests enhanced disclosure about program rights in MD&A related to the results of operations, liquidity and capital resources and critical accounting estimates. The SEC staff comments focus on providing investors insight into material opportunities, challenges and risks related to program rights.

**Analysis of current issues**

Registrants in the media and entertainment industry typically acquire programming to monetize through advertising-supported or subscription-based business models. Because consumer viewing patterns change, registrants continue to alter the type of programs they exhibit. The programs may be licensed for short or long periods, and the cash flows associated with each license arrangement may vary.

A license arrangement for programming is accounted for in accordance with ASC 920. Under ASC 920, the licensee reports both an asset and liability for the rights acquired when the license period begins, the cost of each program is known or reasonably determinable, the programming has been accepted by the licensee and the program is available for its first showing or telecast. The capitalized costs are amortized based on the estimated number of future showings, except licenses with unlimited showings, which may be amortized over the period of the agreement. If the first showing is more valuable than repeats, an accelerated method of amortization is used. However, straight-line amortization may be used if each showing is expected to generate similar revenues. The capitalized costs are reported at the lower of amortized cost or estimated net realizable value.

The SEC staff often asks registrants to provide additional disclosures about their past and future programming initiatives and strategies. The discussion should include whether a registrant expects to increase program rights expenditures and whether it expects to increase the amortization of program rights in future periods.

The SEC staff may ask registrants to disclose program costs in relation to the total costs of revenue and the underlying reasons for any increase in costs in relation to total revenues. A registrant also may be asked to provide a more detailed analysis of its use of cash to obtain programming rights.

The SEC staff looks closely at registrants’ critical accounting policies and estimates, asking them to provide enhanced disclosures about their policies to determine write-downs and the net realizable value of each program or group of programs. A registrant may be asked to describe the amortization method for its program rights and discuss whether there have been recent changes.

The SEC staff requests that registrants provide more robust disclosures in their MD&A of critical accounting estimates regarding the underlying assumptions, how the estimates were determined, how accurate the estimates have been in the past and how likely the estimates are to change in the future.
Consolidation of local marketing agreements

For further discussion, please refer to the MD&A section of this publication.

**Resources**

- [2011 SEC annual reports – Form 10-K (SCORE No. CC0337), Ernst & Young, November 2011.](#)

**Summary of issues noted**

The SEC staff asks broadcasters that enter into local marketing agreements (LMAs) to address the guidance in ASC 810-10-25-38 when determining whether to consolidate an entity that holds the broadcast license and related broadcast assets (the station).

**Analysis of current issues**

LMAs are used in the broadcast industry to enable enterprises to achieve economies of scale or for strategic purposes by combining the operations of stations in certain markets in which FCC regulations would otherwise prohibit an outright acquisition. Because FCC broadcast licenses and the related broadcasting assets generally are held by a separate legal entity, the provisions of the variable interest entity (VIE) model usually apply to these arrangements.

Although LMAs may take various forms, an enterprise typically obtains the right to operate the broadcast assets of the station. Generally, enterprises operating a station under a LMA pay a fixed monthly fee to the licensor (i.e., holder of the FCC broadcast license). Under the terms of an LMA, the licensor and operator both maintain responsibility for the station’s programming to comply with FCC rules and regulations. Accordingly, an LMA must give the licensor (1) the ability to terminate the agreement or (2) veto power over programming that it believes would violate FCC standards.

Careful consideration should be given to the terms of the LMA to determine whether it represents a variable interest in the station.

LMAs may contain provisions for certain put or call options on the station’s assets at a future date. Other contractual provisions may protect against a decrease in the fair value of the station assets. These terms should be evaluated carefully under the provisions of the variable interest model because (1) the entity owning the station(s) may be a VIE and (2) the operator or service provider may be that entity’s primary beneficiary.

The SEC staff asks detailed questions about the determination of which party has the power to direct the activities that most significantly affect the VIE’s economic performance. The SEC staff asks registrants to provide additional information that describes which entity determines the programming for the station(s), what decisions can be made unilaterally by each entity and which entity is responsible for liabilities that may arise from broadcast operations.

**Resources**

- [Financial reporting developments – Consolidation of variable interest entities (SCORE No. BB1905), Ernst & Young, June 2011.](#)
Appendix A: Industry supplements

Mining and metals supplement

In this supplement, we analyze trends in SEC staff comment letters related to the mining and metals industry. These topics should be considered in conjunction with the topics in the main section and other appendices that also may be relevant to registrants in the mining and metals industry.

**Mineral resources**

**Summary of issues noted**

The SEC staff has begun requesting that registrants provide cautionary language or a legal disclaimer when they refer to “measured,” “indicated” and “inferred” resources on websites or in press releases. Industry Guide 7 prohibits the use of any terms other than “proven” or “probable” when disclosing reserves in SEC documents.

**Analysis of current issues**

The SEC staff has asked companies that make references on their websites or in press releases to reserve measures other than those recognized by the SEC to accompany such disclosure with the following cautionary language or provide a legal disclaimer:

*Cautionary Note to US Investors — The United States Securities and Exchange Commission permits US mining companies, in their filings with the SEC, to disclose only those mineral deposits that a company can economically and legally extract or produce. We use certain terms on this website (or press release), such as “measured,” “indicated,” and “inferred” resources, which the SEC guidelines strictly prohibit US registered companies from including in their filings with the SEC. US Investors are urged to consider closely the disclosure in our Form 10-K which may be secured from us, or from the SEC website at http://www.sec.gov/edgar.shtml.*

**Properties**

**Summary of issues noted**

The SEC staff may ask for supplemental information about material properties, as required by Instruction 3(b) to Item 102 of Regulation S-K.

**Analysis of current issues**

The SEC staff reminds companies to include in their filings small-scale maps showing the location and access to each material property, as required by Instruction 3(b) to Item 102 of Regulation S-K. These maps and drawings generally must contain the following features:

- A legend or explanation showing, by means of pattern or symbol, every pattern or symbol used on the map or drawing
- A graphical bar scale, along with representations of scale such as “one inch equals one mile” if the scale of the map has not been altered
- A north arrow
- An index map showing where the property is situated in relation to the state or province in which it was located
- A title of the map or drawing, and the date on which it was drawn
• If interpretive data is submitted with a map, the identity of the geologist or
engineer that prepared the data
• Sufficient scale to clearly show all features on the drawing

The SEC staff also asks companies to disclose the information required under paragraph (b) of Industry Guide 7. For each material property, paragraph (b) of Industry Guide 7 requires the following information:

• A brief description of the property's rock formations and mineralization with current or potential economic significance
• A description of any work completed on the property and its present condition
• Details about the physical condition of the plant and equipment, including subsurface improvements and equipment
• A description of equipment, infrastructure and other facilities
• The current state of exploration of the property
• The total costs incurred to date and all planned future costs
• The source of power and water that can be used at the property

If applicable, registrants should provide a clear statement that the property is without known reserves and the proposed program is exploratory in nature.

**Summary of issues noted**

Item 1202(a)(8) of Regulation S-K requires a third-party report to be filed in the annual report if the registrant represents in its filing that a third party prepared or conducted a reserves audit of the registrant’s reserves estimates, or any estimated valuation thereof, or conducted a process review. Item 1202(a)(8) specifies items that should be included in the report. The SEC staff frequently comments on various aspects of these third-party reports.

**Analysis of current issues**

Under paragraph (c) of Industry Guide 7 and Rule 12b-4 of Regulation 12B, the SEC staff may ask for supplemental information for review by an SEC staff engineer, such as the most recent reserve reports that establish the legal, technical and economic feasibility of the mineralization designated as reserves. The SEC staff often questions the pricing used in reserve estimates and compares this pricing with MD&A disclosures for consistency and viability of commercial reserves. The SEC staff also asks registrants to explain how they determined economic reserves as defined in paragraph (a) of Industry Guide 7.
In this supplement, we analyze trends in SEC staff comment letters related to the oil and gas industry. These topics should be considered in conjunction with the topics in the main section and other appendices that also may be relevant to registrants in the oil and gas industry.

Classification and disclosures

Summary of issues noted

Oil and gas registrants were required to adopt the SEC rule, Modernization of Oil and Gas Reporting Requirements, for annual reports filed after 31 December 2009. The SEC staff frequently issues comments to registrants about the required disclosures.

In addition to the areas discussed below, the SEC staff continues to check consistency between a registrant’s reserve disclosures in its financial statements and:

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

Analysis of current issues

Proved undeveloped reserves

The SEC staff focuses on reserves classified as “proved undeveloped” (PUDs). The SEC staff refers to its Compliance and Disclosure Interpretations (C&DI) available at http://www.sec.gov/divisions/corpfin/guidance/oilandgas-interp.htm.

The SEC staff requests that registrants with a large percentage of proved undeveloped reserves expand their disclosure to include the amount and percentage of undeveloped reserves that were converted to developed reserves in each of the last three years. The SEC staff also requests that registrants quantify PUD reserve additions and other material changes due to revisions, drilling, improved recovery or acquisitions and dispositions in accordance with Item 1203(b) of Regulation S-K.

The SEC staff challenges proved classification for areas that are expected to remain undeveloped for more than five years and requests registrants to provide supplemental information about their evaluation of the appropriate classification of those reserves. The SEC staff questions whether registrants that have a development plan that is longer than five years can assert that they have a basis for meeting the reasonable certainty criterion necessary to book proved reserves and whether a “final” investment decision has occurred.

The SEC staff not only looks to see that a plan is in place, but also whether the registrant will be able to execute the plan. The SEC staff asks for specific documentation regarding any PUDs that do not meet or have exceeded the five-year development criterion, and in many cases the SEC staff challenges their classification when the historical conversion rates are less than 20%. The SEC staff also has questioned forecasted conversion of PUDs when there are indications that drilling activity has slowed for the registrant (e.g., when the number of rigs the
registrant is using has decreased). Registrants should challenge whether it is reasonably certain that projects will be completed and whether classification as a PUD reserve remains appropriate.

The SEC staff has requested a detailed discussion of PUDs, including:

- The number of locations and the associated quantity of reserves for those locations to be developed after five years from initial booking
- An explanation why the reserves remain undeveloped
- The estimated time to production and why the reserves remain proved

For PUDs with a development plan exceeding five years, the SEC staff has requested additional information about the specific circumstances that justify a delay in development and has questioned whether the locations should be classified as proved. C&DI 131.03 provides factors that a registrant should consider in determining whether circumstances justify recognizing proved reserves even though development may extend past five years. The SEC staff has specifically requested that registrants support their positions using the factors cited in the C&DI.

**Technical support for reserves**

The SEC staff has focused on new fields and has questioned certain assumptions used to estimate reserves. In certain circumstances, the SEC staff has requested revisions to reserve estimates when it does not believe there is sufficient evidence (direct or through analogy to another field) to support the registrant’s assumptions. The SEC staff has questioned reserve classification and has requested detailed supplemental schedules for proved reserves, including:

- One-line recaps by property in spreadsheet format sorted by field within each proved reserve category including the dates of first booking and estimated first production for proved undeveloped properties
- Total summary income forecast schedules for each proved reserve category with proved developed segregated by producing and nonproducing properties
- Individual income forecasts for some of the largest (net equivalent reserve basis) wells/locations in the proved developed and proved undeveloped categories as well as the authority for expenditure (for evaluation of costs) for each of the PUD locations
- Engineering exhibits (e.g., maps, rate/time plots, volumetric calculations, analogy well performance) for each of the largest properties, including the number of spacing units from the PUD location to the nearest productive well, evidenced by a map and brief narrative in support of the reserves

The SEC staff also has requested information about re-fracture treatments for shale properties as well as how much future investment was assumed and the estimated time interval between re-fracturing and the basis for that estimate.
Changes to proved reserves
ASC 932 requires disclosure of changes in the net quantities of a registrant’s proved oil and gas reserves during the year with appropriate explanation of significant changes (ASC 932-235-50-5). The SEC staff requests additional discussion about the nature of changes to proved reserves that are presented in the reserve rollforward. The SEC staff also requests that registrants include in their filings a discussion of the amount of reserves added in each field or major basin, the number of wells drilled that are associated with those additions and explanations for significant changes (e.g., revisions, extensions, discoveries, acquisitions).

Presentation of reserve types
Item 1202(a)(4) of Regulation S-K requires separate disclosure of material reserves for crude oil, natural gas, synthetic oil, synthetic gas and other nonrenewable natural resources (e.g., bitumen) to be sold and upgraded into synthetic oil and gas. The SEC staff questions registrants when they combine reserves associated with natural gas liquids with either oil or natural gas reserves. While “material reserves” is not defined, the SEC staff frequently requests separate disclosure when such reserves approach 10% of total proved reserves.

Aggregation of reserves
Item 1204 of Regulation S-K requires disclosure of production volumes, production prices and production costs for each geographic area, country and field that contains 15% or more of a registrant’s total proved reserves, unless prohibited by the country in which the proved reserves are located. The SEC staff questions whether registrants appropriately disaggregate their geographic areas and in some cases requests confirmation that no country or field contains more than 15% of total reserves. In other cases, the SEC staff questions the appropriateness of a registrant’s aggregation of countries and continents and how the aggregation is supported under SEC rules.

Example from SEC comment letter: Aggregation of reserves
We note you disclose your oil and gas production, for each of the last three years, by final product sold. Please tell us whether any individual fields contain 15% or more of your total reserves and, if so, why you concluded that the information for each significant field was not required. Refer to Item 1204(a) of Regulation S-K, for additional guidance.

Other areas of focus
Item 1208(b) of Regulation S-K requires disclosure of the amount of any undeveloped acreage, both leases and concessions, expressed in both gross and net acres by geographic area, together with an indication of acreage concentrations and, if material, the minimum remaining terms of leases and concessions. The SEC staff comments focus primarily on whether there are any expiring leases or concessions and ask for disclosure about those expiring in the short term.
The SEC staff also questions registrants that do not provide reserves disclosure for entities accounted for under the equity method. The SEC staff expects ASC 932 reserves disclosure to be provided for equity method investees in registrants' SEC disclosures by geographic area, including price and cost information. However, such information may not be totaled with the registrant's own reserves.

### Resources

- **Hot Topic** – FASB issues ASU 2010-03 to amend oil and gas reserve accounting and disclosure guidance (SCORE No. BB1892), Ernst & Young, 8 January 2010.
- **Hot Topic** – SEC staff updates oil and gas reporting guidance (SCORE No. CC0286), Ernst & Young, 4 November 2009.

### Third-party reports and related process

#### Summary of issues noted

Item 1202(a)(8) of Regulation S-K requires a third-party report to be filed with the registrant's annual report if the registrant represents in its filing that a third party prepared or conducted a reserves audit of all or a portion of the registrant's reserves estimates, or any estimated valuation thereof, or conducted a process review. Item 1202(a)(8) specifies items that should be included in the report. The SEC staff frequently comments on various aspects of these third-party reports as well as the registrant's process for obtaining them.

#### Analysis of current issues

The SEC staff comment letters remind registrants that a discussion of the primary economic assumptions is required in the report. The SEC staff asks registrants to disclose the percentage of reserves (including PUDs) that were examined by third-party engineers as well as how the registrant determined which fields the third party would audit. The SEC staff requests that registrants modify disclosures to comply with the requirements of Item 1202(a)(7) of Regulation S-K, which requires registrants to disclose internal controls used in estimating reserves, including the qualifications and experience of the internal technical person who oversees the reserve estimates.

### Summary of issues noted

The SEC staff is commenting on the disclosures involving registrants' use of hydraulic fracturing as a production technique aimed at maximizing the productivity of wells.

#### Analysis of current issues

The SEC staff asks registrants to address any material operational and financial risks associated with hydraulic fracturing such as any material risks related to underground migration or surface spillage or mishandling of fluids, including chemical additives that may be toxic.
Appendix A: Industry supplements

Example from SEC comment letter: Hydraulic fracturing

Please tell us, with a view toward disclosure:

• The locations of your current and future fracturing activities
• The acreage subject to fracturing
• The percentage of reserves subject to fracturing
• The anticipated costs and funding associated with fracturing activities
• Whether there have been any incidents, citations, or suits related to your fracturing operations for environmental concerns, and if so, what your response has been

In regard to your hydraulic fracturing operations, please tell us what steps you have taken to minimize any potential environmental impact. For example, and without limitation, please explain if you:

• Have steps in place to ensure that your drilling, casing and cementing adhere to known best practices
• Monitor the rate and pressure of the fracturing treatment in real time for any abrupt change in rate or pressure
• Evaluate the environmental impact of additives to the hydraulic fracturing fluid
• Minimize the use of water and/or dispose of it in a way that minimizes the impact to nearby surface water

The SEC staff has asked registrants to provide supplemental reports detailing all chemicals used in their hydraulic fracturing fluid formulation or mixture, in volume and concentration and total amounts used, for representative wells in each basin where fracturing is used. The SEC staff asks registrants to disclose all material information about any potential liability that might result if a connection is established between environmental contamination and the registrant’s operations including the following:

• Applicable policy limits related to the registrant’s insurance coverage
• Indemnification obligations
• Whether existing insurance would cover any claims made against the registrant or on behalf of individuals who are not employees of the registrant, in the event of personal injury or death, and whether customers would be obligated to indemnify the registrant for any such claims
• Insurance coverage with respect to pollution liability and associated environmental remediation costs
• Further details on the risk that is insured for hydraulic fracturing operations

The SEC staff has asked registrants that use hydraulic fracturing to assess the adequacy of their disclosures related to potential environmental contamination.
In this supplement, we analyze trends in SEC staff comment letters related to the provider care industry. These topics should be considered in conjunction with the topics in the main section and other appendices that also may be relevant to registrants in the provider care industry.

Summary of issues noted
The SEC staff asks that registrants in the provider care industry expand their disclosures about certain payments received from governmental and third-party payors.

Analysis of current issues
The changing health care landscape over the last several years has resulted in the receipt of nontraditional payments by provider care organizations. The American Recovery and Reinvestment Act of 2009 and the Affordable Care Act of 2010 (ACA) allowed for the creation of the Medicare and Medicaid electronic health records (EHR) incentive payment program and the Medicare Shared Saving Program. Other state governments and third-party payors have followed suit, establishing contracts or arrangements with provider care organizations that allow the provider to share in the risks and rewards of lowering the overall cost of patient care. These nontraditional payments to provider care organizations often have unique revenue recognition considerations.

In the last year, the SEC staff has increased its focus on these types of payments. In particular, the SEC staff has asked registrants to disclose in future filings their income or revenue recognition accounting policy for these payments and how these criteria were met when the benefits of those payments were recognized. The SEC staff also has challenged the basis of classification of these payments in the income statement (e.g., as part of net patient service revenue, other revenues or other income).

Additionally, with the pending implementation of many provisions of the ACA, we anticipate the SEC staff will be looking for more disclosure in MD&A about the current and anticipated effects of the ACA.

Summary of issues noted
Registrants in the provider care industry are required to expand disclosures about the allowance for doubtful accounts for patient accounts receivable and net patient service revenue to comply with the requirements of ASU 2011-07, which is effective for fiscal years beginning after 15 December 2011 and interim periods within those years.

Analysis of current issues
ASU 2011-07 will provide greater transparency regarding patient service revenue and related bad debts by requiring additional financial statement disclosures. The amendments require (1) disclosures about management’s policy for assessing the timing and amount of uncollectible patient service revenue recognized as bad debts by major payor source of revenue, (2) qualitative and quantitative disclosures about significant changes in the allowance for doubtful accounts related to patient accounts receivable and (3) disclosure of patient service revenue by major payor source provided retrospectively.
Given the required implementation of ASU 2011-07, we anticipate the SEC staff will be assessing whether all relevant disclosures have been included in the respective filing. Registrants should pay particular attention to compliance with these new financial statement disclosure requirements.

**Resources**

*Financial reporting briefs – Provider care* (SCORE No. BB2398), Ernst & Young, September 2012.

*Financial reporting briefs – Provider care* (SCORE No. BB2320), Ernst & Young, March 2012.

*2011 SEC annual reports – Form 10-K* (SCORE No. CC0337), Ernst & Young, November 2011.
In this supplement, we analyze trends in SEC staff comment letters related to the real estate industry. These topics should be considered in conjunction with the topics in the main section and other appendices that also may be relevant to registrants in the real estate industry.

**Summary of issue noted**

When properties are acquired in a business combination, the SEC staff commonly requests information about acquired assets and liabilities recognized related to operating leases. In particular, the SEC staff asks registrants to provide additional information about the consideration of below-market lease renewal provisions when estimating the fair value of in-place leases.

**Analysis of current issue**

In a business combination that includes assets subject to operating leases, such as real estate with in-place leases, an assessment is required to determine whether the underlying operating leases have in-place value, as well as provisions that are favorable or unfavorable, given market conditions that existed on the date of the acquisition and the terms and conditions of the existing leases. The fair value of the underlying property and any asset or liability related to the lease contracts are recognized and measured separately. The fair value of the in-place lease should consider all provisions of the lease (e.g., term, purchase options, renewal options, termination penalties) and should be estimated in accordance with ASC 820.

The SEC staff asks for additional information about how management considers all provisions of the lease when estimating the fair value of in-place leases. As it relates to below-market leases, the SEC staff may ask registrants to explain how management assesses the likelihood of a tenant exercising its below-market renewal option when determining the fair value and related amortization periods.

**Example from SEC comment letter: Below-market operating leases**

Please tell us how you considered any fixed rate renewal options in the calculation of the fair value of the below market lease intangibles and the period over which your below market lease intangibles are amortized. Your response should also discuss how you determine the likelihood that a lessee will execute a below-market lease renewal, and how you consider the likelihood, if at all, in determining the amortization period.

**Resources**

*Financial reporting developments – Lease accounting (SCORE No. BB1793), Ernst & Young, October 2011.*
Capital expenditures

Summary of issues noted
The SEC staff requests enhanced disclosures about registrants’ cost capitalization policies in the MD&A discussion of critical accounting estimates. Additionally, the SEC staff asks registrants to provide additional disclosures about the nature of capital expenditures.

Analysis of current issues
Because applying the Real Estate Project Costs subsection of ASC 970 requires significant judgment and there is diversity in practice, the SEC staff is focused on transparent disclosure in this area.

In particular, the SEC staff requests that registrants disclose:
- The types of soft costs that they capitalize, particularly indirect costs
- The methodology they used to allocate indirect costs, as well as the amount of indirect personnel and administrative costs that they capitalized in each year presented
- The amount of payroll costs and other overhead costs that they capitalized
- The capitalization period including when capitalization begins and ends

The SEC staff also focuses on whether capital expenditure disclosures (on the face of the statement of cash flows or in MD&A) provide sufficient transparency regarding the nature of capital expenditures. Registrants should disclose and discuss separately capital expenditures related to acquisitions, new developments, redevelopments and improvements to existing properties.

Resources
2011 SEC annual reports — Form 10-K (SCORE No. CC0337), Ernst & Young, November 2011.

Funds from operations

Summary of issues noted
The SEC staff requests that registrants identify whether management considers funds from operations (FFO) and other non-GAAP financial measures to be key performance indicators. The SEC staff also frequently issues comment letters requesting that registrants provide additional or modified disclosures when presenting FFO and other non-GAAP financial measures.

Analysis of current issues
The SEC staff’s interpretive guidance states that management should clearly identify which performance indicators are considered to be key. FFO is a widely used non-GAAP supplemental measure of the financial performance of a real estate investment trust (REIT). The market closely follows REIT FFO expectations, and investors and analysts view FFO as a key industry performance indicator.
In its January 2010 non-GAAP Compliance and Disclosure Interpretations (C&DI 102.01 and 102.02), the SEC staff noted that FFO refers to the measure defined by the National Association of Real Estate Investment Trusts (NAREIT). FFO as defined by NAREIT adjusts net income by excluding gains or losses on asset sales and adding back depreciation and amortization, among other things.

Recently, the SEC staff advised NAREIT that it will not object if registrants exclude impairment charges from their FFO metrics. This is a change from the SEC staff's previous view of objecting to the exclusion of impairment charges from FFO metrics. Further, the SEC staff clarified that FFO may be presented on a basis other than that defined by NAREIT as long as the registrant clearly discloses how its calculation differs from NAREIT’s definition.

Summary of issues noted
The SEC staff recently has started seeking greater transparency regarding the classification of certain expenses within the statement of operations.

Analysis of current issues
Registrants in the real estate industry incur significant property level expenses, which can affect net operating income (NOI), depending on how those expenses are classified in the statement of operations. Since management often considers NOI a key performance measure, the SEC staff focuses on MD&A related to property level expenses. Specifically, the SEC staff asks registrants to clarify in MD&A the types of costs they include in property level operating expenses and in general and administrative expenses. The SEC staff’s comments seek to increase transparency of the registrant’s results of operations and to enhance comparability across the industry.

Example from SEC comment letter: Classification of costs
Please revise future filings to clarify what expenses are included in property level operating expenses and what expenses are included in general and administrative expenses. Within your response, please provide an example of your proposed disclosure.

Resources
2011 SEC annual reports – Form 10-K (SCORE No. CC0337), Ernst & Young, November 2011.
In this supplement, we analyze trends in SEC staff comment letters related to the retail and consumer products industries. These topics should be considered in conjunction with the topics in the main section and other appendices that also may be relevant to registrants in the retail and consumer products industries.

Summary of issues noted

The SEC staff requests that registrants, primarily in the retail industry, expand their disclosures related to the recognition of gift card revenue in the financial statements. The requested disclosures include the amount of revenue related to gift cards and the manner in which registrants recognize revenue related to the portion of the gift card that ultimately may not be used by the customer for the purchase of goods or services (commonly referred to as breakage). The SEC staff expects disclosure addressing the amount of breakage recognized if it is material to the registrant.

Analysis of current issues

Many retailers sell gift cards that entitle the holder of the card to redeem it for goods and services during a redemption period, which may be specified or unspecified. Customers often do not redeem the full amount of gift cards, resulting in breakage. When a retailer is not statutorily required to escheat the unused amounts to a state or other taxing authority, a question often arises about how it should account for the breakage that is expected or that occurs.

Currently, there is no authoritative literature on accounting for gift card breakage. Generally, the liability associated with the gift card sold should be derecognized only if it has been extinguished through payment of the obligation or by legal release from the liability (ASC 860). Subject to applicable laws, some retailers charge a service fee on customers’ unused gift card balances that, over time, amortizes any unused balances into income. Charging a service fee is a term and condition of the sale of the gift card that provides the retailer with a legal release from its obligation to the customer. However, many retailers do not charge service fees, or, when they do, the amount of the fee may not be sufficient to fully amortize unused gift card balances.

Applying the guidance in ASC 860 could result in the indefinite deferral of unused gift card balances that do not otherwise have to be escheated to a state or other taxing authority. However, the SEC staff generally does not object to derecognizing the liability by analogy to ASC 450 when a retailer has sufficient company-specific customer experience to indicate when the chance of a customer requiring performance is remote, and the amount of breakage can be objectively and reliably estimated using company-specific historical evidence.

Methods to account for breakage

The lack of authoritative guidance has led to diversity in practice in accounting for breakage. Most retailers use one of the following methods:

- Breakage is not estimated and recognized into income and therefore is carried on the balance sheet as a liability (i.e., deferred revenue) indefinitely.
Breakage is estimated and recognized into income as part of the normal accounting processes performed each reporting period, taking into account company-specific historical evidence of redemption rates. Breakage is estimated and recognized in one of the following ways:

- Under the “redemption recognition” method, breakage is estimated and recognized as gift cards are used for the purchase of goods or services.

- Under the “delayed recognition” method, breakage is estimated and recognized when it is apparent, based on an aging of gift card balances, that the likelihood of redemption of the outstanding gift card balances is remote.

The SEC staff does not believe it is appropriate to estimate and recognize breakage immediately at the point of gift card issuance.

**Income statement presentation**

Breakage, once recognized, generally should be classified as revenue when the recognition method is tied to the delivery of goods or services. Accordingly, retailers estimating and recognizing breakage into income using either the redemption recognition method or delayed recognition method generally may classify breakage as revenue. When a retailer charges a service fee on customers’ unused gift card balances, registrants often classify the amounts recognized as other income because recognition is not tied to the delivery of goods or services. It is generally not appropriate to recognize breakage as a reduction of an expense line item (e.g., cost of sales, SG&A expense).

**Disclosures**

The SEC staff expects registrants that estimate and recognize breakage to disclose the following in the financial statements:

- The method used to estimate and recognize breakage
- The key assumptions used to establish the estimate
- The income statement classification (revenue or other income) of amounts recognized
- The balance sheet classification of deferred revenue related to the gift card liability

If the amount of breakage recognized is significant to the results of operations, registrants should consider disclosing the amount of breakage recognized. They also should consider whether the estimates used to determine breakage should be discussed as a critical accounting estimate in MD&A.
Example from SEC comment letter: Disclosures

We note your disclosure that proceeds received from the sale of gift cards are recorded as a liability and recognized as sales when redeemed by the holder. Please further describe to us your revenue recognition policy with respect to gift cards, including your policy for gift card breakage and quantify for us the amount of breakage you recognized in each of the past three years. Also confirm to us that you will enhance your disclosure in future filings to describe your policy for gift card breakage, and provide us with the text of your proposed future disclosure.

Summary of issues noted
The SEC staff asks registrants to provide additional disclosures about critical accounting estimates for key financial statement items common in the retail and consumer products industries, such as inventory and allowances for sales returns and doubtful accounts.

Analysis of current issues
The SEC staff requests that registrants in the retail and consumer products industries provide more robust disclosures in their critical accounting estimates about the underlying assumptions, how the estimates were determined, how accurate the estimates have been in the past and how likely the estimates are to change in the future. In light of the continued challenging economic environment for the retail industry, the SEC staff also requests expanded discussion addressing the effect of current economic trends and conditions on the registrant’s ability to make its critical estimates.

For example, the SEC staff requests that retailers and consumer products companies expand their disclosures about the estimates and judgments used in valuing inventories, particularly relating to markdowns and shrinkage. Additionally, the SEC staff requests disclosure of the specific estimates and assumptions used to determine net realizable value of inventory for purposes of determining the need for lower of cost or market adjustments.

Retailers and consumer products companies also have been asked to expand their disclosures about accounting policies for product returns and the basis for their conclusions that product returns can be reasonably estimated. The SEC staff also has challenged whether the use of historical return rates is appropriate for estimating returns of new products.

Similarly, the SEC staff requests further discussion of management’s judgments and estimates in determining the allowance for doubtful accounts, as well as additional quantitative information in MD&A to address the risks associated with the collectibility of receivables and the likelihood that additional charges/provisions will be needed.

For further discussion, please refer to the MD&A section of this publication.

Resources
2011 SEC annual reports – Form 10-K (SCORE No. CC0337), Ernst & Young, November 2011.
In this supplement, we analyze trends in SEC staff comment letters related to the technology industry. These topics should be considered in conjunction with the topics in the main section and other appendices that also may be relevant to registrants in the technology industry.

Summary of issues noted
For software arrangements that include hosting services (i.e., software-as-a-service or cloud services), the SEC staff frequently asks registrants to clarify whether customers have the right to take possession of software without significant penalty.

Analysis of current issues
The software accounting literature provides a framework to determine whether a software hosting arrangement contains a software deliverable. The key to determining whether service or software accounting should be followed depends on whether a software element exists. Determining whether a software element exists depends on whether the customer has a substantive right to take possession of the licensed software and use it for the customer’s intended purpose without further use of the hosting services. In accordance with ASC 985-605-55-121, the software element of a hosting arrangement would be subject to software revenue recognition guidance of ASC 985-605 if both of the following criteria are met:

- The customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty
- The customer can feasibly run the software on its own hardware or have the software hosted by a third party

In its comments, the SEC staff focuses on whether customers can take possession of the software without significant penalty. A significant penalty is defined using two distinct criteria: (1) the ability to take delivery of the software without incurring significant cost and (2) the ability to use the software separately without a significant diminution in utility or value. Both conditions must be satisfied for a software vendor to determine that a significant penalty does not exist.

If a software hosting arrangement is not subject to ASC 985-605, it generally is accounted for as a service contract in accordance with the general revenue recognition guidance in SAB Topic 13 and the provisions of the multiple-element arrangements guidance in ASC 605-25, if applicable.

Resources
Summary of issues noted

For transactions within the scope of ASC 985-605, the SEC staff continues to question the determination of vendor-specific objective evidence (VSOE) of fair value. Software vendors are required to have VSOE for any undelivered elements to separately account for the delivered items within a multiple-element software arrangement.

Registrants may be asked to provide specific information about the methods used to support VSOE, as well as the results of those methods, so the SEC staff can better assess the effectiveness of those processes and the vendor’s conclusions. The SEC staff also asks registrants to provide additional accounting policy disclosures regarding their evaluation of VSOE. Registrants may be asked to provide clarification about the overall process used to establish VSOE, including their consideration of customer type, population size and various pricing factors. Questions on VSOE focus primarily on post-contract customer support (PCS) included in software contracts because that is generally the last element to be delivered in a multiple-element arrangement.

Analysis of current issues

The evaluation of VSOE can be highly subjective and is often affected by a number of factors, which may include purchase volume, competitive pricing, duration of the arrangement, geographic region, distribution channel (e.g., resellers, distributors), customer type, nature and type of product and the specific terms of arrangements. The SEC staff consistently asks for clarification of how various factors were considered by the registrant when evaluating VSOE for PCS, often citing specific factors that appear to have an effect on pricing based on a review of the registrant’s filing, including statements made in MD&A. In addition to registrant filings, the SEC staff also cites specific factors based on a review of a registrant’s marketing materials or website.

The SEC staff also asks for detailed information regarding the specific methodology applied by a registrant to determine VSOE and quantification of the results of that application. Registrants should be prepared to respond to these types of detailed questions. For example, to establish VSOE of PCS for each identified customer class, two approaches generally are used: the “bell-shaped curve” and “substantive renewal rate.” Either of these approaches would be consistent with the principle underlying the VSOE requirement in ASC 985-605 (i.e., that VSOE exists when similar prices are charged for similar items when sold separately, such as PCS renewals).

The primary questions the SEC staff asks about the bell-shaped curve approach include:

- How the registrant determined a reasonable range for purposes of establishing VSOE
- What percentage of standalone sales is within the narrow pricing range
- How the arrangement consideration is allocated to PCS when a contractually stated rate falls outside the range
The SEC staff's primary comments about the substantive renewal rate approach include:

- How the registrant determined that renewal rates are substantive
- What percentage of customers actually renew at the stated rates
- How the arrangement consideration is allocated to PCS when stated renewal rates are above or below the "normal" range
- How negative pricing pressures on PCS renewal rates affect the assertion that stated contractual prices are substantive and within a narrow range

Resources


Summary of issues noted

ASU 2009-14 modified the software revenue recognition guidance in ASC 985-605, significantly affecting how registrants account for revenue arrangements containing both hardware and software elements. The SEC staff issues comments seeking clarification of various matters related to this revised guidance, including whether the software components of an arrangement are essential to the functionality of the product.

Analysis of current issues

ASU 2009-14 revised the software revenue recognition guidance by providing a scope exception for many transactions that were previously within the scope of ASC 985-605. Under the revised guidance, when an arrangement (e.g., sales contract) contains both hardware and software components, the hardware will always be considered to be outside the scope of the software revenue recognition guidance. Further, if it is determined that hardware and software components work together to deliver the essential functionality of the product, the essential software and any undelivered elements related to that essential software (such as PCS) also should be excluded from the scope of the software revenue recognition guidance. Prior to this change, arrangements containing both hardware and software components were frequently accounted for based on the guidance of ASC 985-605 because the software component was considered more than incidental to the product or service.

The determination of whether the software and hardware components function together to deliver a product’s essential functionality should be made from the vendor’s perspective. Based on the facts and circumstances of an arrangement, this determination may be difficult and may require considerable professional judgment. ASU 2009-14 provides several indictors and examples for a registrant to consider when performing its analysis.
For arrangements where the software components are determined to be non-essential to a product’s functionality (and therefore within the scope of ASC 985-605), the SEC staff questions how the total arrangement consideration is allocated among the non-essential software components and the hardware components. The arrangement consideration should be allocated using the relative-selling-price method pursuant to the multiple-element arrangement guidance in ASC 605-25.

**Resources**

*Financial reporting developments – Software – Revenue recognition, Accounting Standards Codification 985-605 (SCORE No. BB1946), Ernst & Young, September 2012.*

**Up-front fees**

Service arrangements frequently include non-refundable up-front payments from customers. The SEC staff commonly asks registrants to provide their basis of determining the period over which up-front fees are recognized as revenue in arrangements with only a single deliverable, particularly when the recognition period is the same as the contract life.

**Analysis of current issues**

Many technology companies, such as cloud services vendors, receive payments from customers in advance of rendering a contracted service or delivering a product. Up-front fees generally relate to the initiation, activation or set up of a product to be delivered or a service to be rendered in the future. This issue has been addressed by the SEC staff in SAB Topic 13, which notes that in arrangements containing a single deliverable, unless the payment of an up-front fee represents a culmination of a separate earnings process (i.e., exchange for products delivered or services performed), deferral of revenue is appropriate.

If up-front fees are deferred, vendors must determine the appropriate period over which to recognize them as revenue. SAB Topic 13 states that the recognition period for the up-front fee should extend beyond the contractual period if renewals or additional contracts that would extend the life of the customer relationship beyond the initial term are expected. Therefore, revenue should be systematically recognized over the longer of the contractual period or the estimated customer life. A systematic method would be on a straight-line basis, unless evidence suggests that revenue is earned in a different pattern.
In this supplement, we analyze trends in SEC staff comment letters related to the telecommunications (telecom) industry. These topics should be considered in conjunction with the topics in the main section and other appendices that also may be relevant to registrants in the telecom industry.

**Summary of issues noted**
The SEC staff often asks telecom registrants how they determine whether to present revenues generated from their relationships with content providers or indirect retailers on a gross or net basis.

**Analysis of current issues**
Wireless telecom registrants frequently enter into revenue-generating arrangements with separately owned retail outlets (i.e., indirect retailers) to sell handsets and service contracts to end-user customers. The terms of these arrangements vary throughout the industry. In some cases, the telecom registrant may sell the handset to the indirect retailer and then pay a commission to that indirect retailer once the handset and service contract are sold to the customer.

Wireless telecom registrants also enter into arrangements with content providers to obtain content (e.g., games, music, other applications) to be provided to customers. When the content is downloaded by the customer, the registrant bills the customer either a one-time or monthly usage fee and pays the content providers in accordance with their respective arrangements.

In both of these circumstances, telecom registrants must determine whether to report the revenue generated from these arrangements based on (1) the gross amount billed to a customer because it has earned revenue from the sale of the goods or services or (2) the net amount retained (i.e., the amount billed to a customer less the amount paid to the retailer or content provider) because it has earned a commission or fee. The objective is to determine whether the telecom registrant is in substance acting as the principal that holds substantially all of the risks and benefits related to the sale of a product (e.g., the handset or content).

For further discussion, please refer to the *Gross versus net presentation* discussion in the *Revenue recognition* section of this publication.

**Resources**

*2011 SEC annual reports – Form 10-K (SCORE No. CC0337), Ernst & Young, November 2011.*
The SEC staff’s comments to Foreign Private Issuers (FPIs) often are similar to its comments to domestic registrants. These comments involve financial reporting matters whether the FPI prepares its financial statements in accordance with US GAAP or International Financial Reporting Standards (IFRS). Many of the topics in the main and industry supplement sections of this publication are equally relevant for FPIs, such as:

- MD&A matters, including comments on critical accounting estimates, results of operations and liquidity
- Risk factors
- Accounting for significant assets and liabilities, including financial instruments, investments, intangible assets, accruals that require judgment and contingencies
- Operating items, including revenue recognition, hedging and impairment
- Income taxes, including deferred tax assets and foreign earnings
- Lending activities and the related allowance for credit losses

The SEC staff has publicly commented on the importance of disclosures about sovereign debt exposures for companies in all industries. In January 2012, the SEC’s Division of Corporation Finance issued CF Disclosure Guidance: Topic No. 4: European Sovereign Debt Exposures to help registrants determine what they should disclose about their European debt exposure (i.e., exposure to both sovereign and non-sovereign debt). Due to continued economic uncertainties in Europe, the SEC staff expects disclosure in the notes to the financial statements, as well as outside the financial statements (e.g., risk factors or MD&A), about exposures to distressed European countries such as Greece, segregated by the type of exposure (e.g., sovereign debt; debt issued by companies in, or with significant operations in, the distressed country).

The SEC staff also has made observations regarding reporting matters for registrants that are first-time adopters of IFRS as issued by the International Accounting Standards Board (IASB). Most recently these observations were for Canadian registrants, but they may be relevant to registrants from other countries that adopt IFRS in the future. Common themes observed by the SEC staff include:

- Incomplete disclosure in the financial statements regarding compliance with IFRS as issued by the IASB in the financial statements
- Lack of disclosure of exceptions or exemptions applied in adopting IFRS 1, First-time adoption of International Financial Reporting Standards

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We do not cover IFRS-specific accounting topics in this publication. However, at the 2011 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff identified several common themes in its comment letters issued on IFRS financial statements. These themes are consistent with the themes in its comment letters issued to US GAAP filers, such as those focused on the fair value of financial instruments, the impairment of financial and nonfinancial assets, revenue recognition, income taxes, the factors used to identify operating segments and classification of cash flows.
Auditor not subject to Public Company Accounting Oversight Board inspection

- Insufficient detail provided in IFRS 1 reconciliations from previous GAAP to IFRS
- Inappropriate use of home country GAAP and/or IFRS in selected financial data and MD&A
- Inclusion of IFRS financial statements under Item 17 of Form 20-F when Item 18 would be more appropriate

Below are topics and specific matters that the SEC staff routinely raises in comments to FPIs. Some of these topics, including non-GAAP financial measures and activities with countries designated as state sponsors of terrorism, also apply to domestic registrants.

Summary of issues noted
For registrants in a foreign jurisdiction that has not permitted the Public Company Accounting Oversight Board (PCAOB) to conduct principal auditor inspections, the SEC staff has recently begun to ask that they disclose that fact as a risk factor.

Analysis of current issues
All audit firms registered with the PCAOB, including foreign audit firms, are subject to inspection by the PCAOB. But the legal or regulatory frameworks in some countries (e.g., China, France) currently prohibit the PCAOB from inspecting the audit work performed by audit firms in those jurisdictions. The SEC staff views this as a significant risk factor and expects registrants in these jurisdictions to clearly disclose that the PCAOB cannot inspect the audit work of their auditor, including their quality control procedures.

The SEC staff has not objected to registrant requests to provide the disclosure in future filings. However, the SEC staff has stated that it would expect the disclosure to be made in the next “filed” document and not necessarily the next annual report (e.g., Form 20-F).

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A list of issuers that are audit clients of PCAOB-registered firms from non-US jurisdictions where the PCAOB is denied access to conduct inspections is available at: http://pcaobus.org/International/Inspections/Pages/IssuerClientsWithoutAccess.aspx.
Example from SEC comment letter: Auditor not subject to PCAOB inspection

As a public company, your auditor is required by law to undergo regular Public Company Accounting Oversight Board (PCAOB) inspections to assess its compliance with US law and professional standards in connection with its audits of financial statements filed with the SEC. The PCAOB, however, is currently unable to inspect the audit work and practices of your auditor (see http://pcaobus.org/International/Inspections/Pages/IssuerClientsWithoutAccessList.aspx). As a result of this obstacle, investors in US markets who rely on your auditor’s audit reports are deprived of the benefits of PCAOB inspections of auditors. Therefore, please state this fact under a separate risk factor heading. Explain that this lack of inspection prevents the PCAOB from regularly evaluating your auditor’s audits and its quality control procedures.

Activities with countries designated as state sponsors of terrorism

Summary of issues noted
The SEC staff frequently asks FPIs to provide incremental information about business activities in or with countries identified by the US State Department as state sponsors of terrorism, which currently are Cuba, Iran, Sudan and Syria. If an FPI has been identified as having any business operations in or with one of those countries, the SEC staff periodically (e.g., every year or two) asks for updates on those activities.

Analysis of current issues
US securities laws do not impose a specific disclosure requirement that addresses business activities in or with a country based on its designation as a state sponsor of terrorism. However, Rule 408 of Regulation C and Exchange Act Rule 12b-20 require a registrant to disclose additional information if it is material and necessary to make its filings not misleading, given the registrant’s facts and circumstances. Because of these rules, the SEC staff frequently asks registrants to provide and, based on materiality, to disclose the following:

- The nature and extent of past, current and any anticipated operations in or with a country designated as a state sponsor of terrorism, whether through subsidiaries, affiliates, joint ventures, distributors, resellers or other direct or indirect arrangements
- Any agreements, services or other contracts registrants have had with the governments, or entities controlled by the governments, designated as state sponsors of terrorism
- Whether registrants have offices, facilities, equipment, ground services, sales agents or other employees in such countries
- Whether any of the technologies or materials provided or intended to be provided to a country designated as a state sponsor of terrorism are controlled items included in the US Department of Commerce’s Commerce Control List
Whether operations in or with state sponsors of terrorism constitute a material risk in quantitative terms by discussing revenues, assets and liabilities associated with such operations and qualitative factors that a reasonable investor would deem important in making an investment decision.

Example from SEC comment letter: Activities with countries designated as state sponsors of terrorism

Please discuss the materiality of any contacts with Cuba, Iran, Sudan and Syria described in response to the foregoing comments, and whether those contacts constitute a material investment risk for your security holders. You should address materiality in quantitative terms, including the approximate dollar amounts of any associated revenues, assets, and liabilities for the last three fiscal years and the subsequent interim period. Also, address materiality in terms of qualitative factors that a reasonable investor would deem important in making an investment decision, including the potential impact of corporate activities upon a company’s reputation and share value. As you may be aware, various state and municipal governments, universities, and other investors have proposed or adopted divestment or similar initiatives regarding investment in companies that do business with US-designated state sponsors of terrorism. Your materiality analysis should address the potential impact of the investor sentiment evidenced by such actions directed toward companies that have operations associated with Cuba, Iran, Sudan or Syria.

Summary of issues noted

Regulators and development banks around the globe have escalated their efforts to fight corruption, including bribery. In many cases, these initiatives have led to stricter laws, increased enforcement and harsher punishment.

Analysis of current issues

The number of SEC enforcement cases related to corruption, including those involving FPIs, has increased significantly in recent years. When an FPI is subject to a regulatory or judicial action, the outcome and root cause should be closely evaluated by the registrant for potential financial reporting implications. The SEC staff will challenge the propriety and completeness of related disclosures in that FPI’s filings. Often, the risk factors, legal proceedings, MD&A and financial statement sections of the filing are affected.

US GAAP expertise

Summary of issues noted

The SEC staff often asks FPIs to provide the background of individuals who are involved in the company’s financial reporting and to describe the qualifications of their audit committee financial expert.

Analysis of current issues

The SEC staff has been requesting that FPIs, particularly those reporting under US GAAP, provide background information on individuals who are primarily responsible for preparing their books, records and financial statements, as well as those who are
ultimately responsible for financial reporting and the effectiveness of internal control over financial reporting. Specifically, the SEC staff often requests the following about individual(s) identified in the inquiry:

- Their role in preparing the financial statements and evaluating the effectiveness of internal control
- Their relevant education and ongoing training on US GAAP and SEC reporting matters
- Any professional designations, such as US Certified Public Accountant or Certified Management Accountant
- Professional experience, including experience preparing or auditing financial statements prepared in accordance with US GAAP and evaluating the effectiveness of internal control over financial reporting
- The nature of any contractual or other relationship with the company

When no members of management have experience with US GAAP, the SEC staff challenges whether effective internal control over financial reporting exists to prepare financial statements in accordance with US GAAP. In those situations, the SEC staff expects the registrant to explain how it achieves effective internal control over financial reporting (e.g., a third party engaged to assist with conversion to US GAAP). If a company states that an accounting firm or other organization prepares its financial statements or evaluates the effectiveness of its internal control over financial reporting, the SEC staff frequently asks for:

- The name and address of the accounting firm or organization
- The qualifications of its employees who perform the services
- How and why the company or organization is qualified to prepare the financial statements or evaluate internal control over financial reporting
- Total fees paid to the accounting firm or organization

When the SEC staff believes that those responsible for the financial statements and the effectiveness of internal control over financial reporting do not possess adequate US GAAP and SEC reporting experience or educational background, the SEC staff expects the company to:

- Disclose a material weakness in internal control
- Discuss how the company plans to remedy the material weakness
- Disclose the effect of this weakness on management’s conclusion regarding disclosure controls and procedures
- Address this weakness in the risk factor section of the filing

When an audit committee member is identified by an FPI as a financial expert, the SEC expects the FPI to describe his or her qualifications, including the extent of the individual’s knowledge of US GAAP and internal control over financial reporting.
Summary of issues noted

The SEC staff challenges whether non-GAAP financial measures disclosed in filings of FPIs are required or expressly permitted by local accounting and disclosure standards. If such disclosures are required or permitted by local standards, the non-GAAP measures may be presented pursuant to a Regulation G exemption without significant additional disclosure. The SEC staff also challenges the usefulness of other non-GAAP financial measures disclosed in FPI filings.

Analysis of current issues

Companies preparing their disclosures under a reporting framework other than US GAAP are often required by local rules and regulations to disclose items that the SEC staff otherwise considers to be non-GAAP financial measures. The SEC staff evaluates all non-GAAP items, including those expressed as percentages or per-share amounts. When an FPI presents non-GAAP items and it is unclear whether they qualify for the Regulation G exemption, the SEC staff asks the registrant to address the following:

- Whether the item is required or permitted by the issuer’s reporting framework
- The literature that the company relied on to conclude that the issuer’s reporting framework either requires or permits disclosing the item
- When permitted, the economic substance behind management’s decision to disclose the item

When the non-GAAP measure is not exempt under Regulation G, the SEC staff asks FPIs to disclose:

- An explanation of how the item provides meaningful information to investors
- How management uses the non-GAAP item to conduct or evaluate its business
- Whether the financial effect of recurring items, if any, that are excluded from a non-GAAP measure will disappear or become immaterial in the near term, and the basis for that conclusion
- The material limitations of using the non-GAAP measure, compared with using the most directly comparable GAAP measure, and how management compensates for these limitations when using the non-GAAP financial measure
- A reconciliation of the item to the most directly comparable GAAP measure, either US GAAP or IFRS, as appropriate

The SEC staff also frequently asks registrants to avoid using confusing titles and descriptions for non-GAAP measures that are the same as, or similar to, titles or descriptions used in US GAAP or IFRS.

In addition, consistent with Item 10(e) of Regulation S-K, the SEC staff challenges the usefulness of non-GAAP items disclosed in FPI filings and makes inquiries similar to those it makes of domestic registrants. For further discussion, refer to the Non-GAAP financial measures discussion in the MD&A section of this publication.
Home-country to US GAAP reconciliations

Summary of issues noted
In reviewing the nature of reconciliations between home-country GAAP and US GAAP, the SEC staff often comments when it expects differences in the reconciliation, but no differences are disclosed. In addition, when reconciling items are presented multiple times in the filing, the SEC staff comments on inconsistencies it identifies within the filing.

Analysis of current issues
When an expected reconciling item between home-country GAAP and US GAAP is not disclosed, the SEC staff asks for an explanation. The SEC staff also asks registrants to explain any material changes in the reconciling items between different periods. Additionally, the SEC staff regularly questions differences in the classification of operating versus non-operating income (expense) between home-country GAAP and US GAAP. The SEC staff also comments on inconsistencies it identifies in the various presentations of the reconciling items within the filing.
Appendix C: SEC review process and best practices

In its filing reviews, DCF staff concentrates on disclosures and accounting methods that may conflict with FASB or SEC rules or that need clarification.

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In August 2012, DCF Director Meredith Cross announced the creation of an Office of Disclosure Standards that will track whether DCF comment letters have led to improved issuer disclosures. The office is expected to begin operating when a senior officer is appointed.

**Required and selective review**

As required by the Sarbanes-Oxley Act of 2002, DCF staff reviews, at some level, every registrant at least once every three years, but it reviews many registrants more frequently. In addition, DCF staff generally reviews all IPOs and Form 8-K Items 4.01 and 4.02 and selectively reviews other transactional filings, such as those made in connection with business combination transactions, proxy statements or other public offerings. In many cases, DCF staff conducts a preliminary review before determining what level of further review to conduct, as discussed below. Prior to issuing comments, DCF staff considers all public information such as company websites, press releases and analyst calls in addition to the content of the filing.

Due to the increased regulation affecting the banking industry, in July 2010 DCF created Assistant Director’s Office 12 (AD 12) that is responsible for reviewing large financial institutions. AD 12 is expected to expand to include more registrants, such
as broker-dealers. DCF staff has commented that the filing review process for registrants assigned to AD 12 is consistent with that for other registrants, but there are “continuous reviews” of some registrants assigned to AD 12 (reviewing and commenting on each filing, as well as intervening press releases, for example).

DCF staff in AD 12 discuss accounting and disclosure implications of reported events and developments on a real-time basis with registrants via telephone. Sometimes these discussions resolve the staff’s questions without the need to issue a formal comment letter or receive a written response from the registrant. It is expected that the process of “continuous reviews” will expand in the future to other Assistant Director offices.

**Levels of review**

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

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

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

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

**DCF staff comments**

DCF staff views the comment process as a dialogue with a registrant about its disclosures. DCF staff’s comments are in response to a registrant’s disclosures and other public information and are based on DCF staff’s understanding of that registrant’s facts and circumstances. At the time of the initial comment letter, DCF staff may be seeking additional information and may not have concluded that there is a deficiency.
Recently, DCF staff began distributing comment letters electronically through emails sent to either the company's chief financial officer or chief accounting officer and sometimes legal counsel. In its comments, DCF staff may request that a registrant (1) provide additional supplemental information in a response letter so it can better evaluate the registrant’s disclosure, (2) amend its SEC filing to revise or supplement its disclosures or (3) provide additional or different disclosures in a future filing with the SEC.

**Best practices for registrant responses to comments**

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

- Responses to each comment should focus on the question(s) asked by the SEC staff, and those responses should cite authoritative literature wherever possible.
- Responses should address the registrant’s unique facts and circumstances. While it may be helpful to consider response letters from other registrants as a resource, registrants should not just copy responses made by other registrants to similar comments.
- Registrants should file all response letters on EDGAR redacting any specific information for which they are seeking confidential treatment.
- If revisions are being made to a filing as a result of a comment from DCF staff, responses should indicate specifically where these revisions are being made. If additional disclosure will be included in a future filing, it may be helpful for the registrant to provide the proposed language in their response letter to avoid an additional comment once the disclosure is filed.
- Companies should seek the input of all appropriate internal personnel and professional advisors (such as legal counsel and independent auditors) to ensure they have fully responded to the comment letter in a complete and accurate manner. Waiting to a later round of comments to involve the necessary resources may delay or hinder a successful resolution.

Registrants should not assume that because DCF staff has issued a comment that it disagrees with the registrant’s disclosures or accounting treatment. Providing a thorough explanation or analysis of an issue to DCF staff beyond the existing disclosure may help DCF staff better understand the accounting and disclosure, and it could resolve the comment. To facilitate such responses, registrants should maintain contemporaneous documentation of significant accounting and disclosure decisions. Judgment applied and documented contemporaneously is more persuasive than a retrospective defense following receipt of a DCF staff comment.
Depending on the nature of the issue, DCF staff’s concerns and the registrant’s response, DCF staff may issue more comments following its review of the registrant’s response. This comment and response process continues until the DCF staff and the registrant resolve all comments.

DCF staff comment letters on certain filings often request a written response within 10 business days. Registrants should contact the DCF staff if they need additional time to respond to comments and ensure that response letters have been thoroughly prepared and reviewed by all appropriate levels. DCF staff is generally accommodating in granting extensions that will enhance the quality of the response letter. Registrants also may consider contacting the DCF staff if they need additional clarification about a comment.

**Closing a filing review**

When a registrant has satisfactorily resolved all DCF staff’s comments on a filing, DCF staff provides the registrant with a letter now referred to as a “completion of review letter” to confirm that the SEC staff’s review of the filing is complete. While the name of the letter has changed from the previous “no further comments letter,” the intent and meaning of the letter remain the same.

To increase the transparency of the review process, when DCF staff completes a filing review, it publicly releases its comment letters and registrant responses to those letters on the SEC’s EDGAR system no earlier than 20 business days after completion of the review, which has been accelerated from the previous period of 45 calendar days.

**Reconsideration process**

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

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

Registrants also may ask the SEC’s Office of the Chief Accountant (OCA), which is distinct from the DCF’s Office of Chief Accountant, to reconsider an accounting conclusion of the DCF staff at any stage in the process. Generally, the Commission’s Office of the Chief Accountant addresses questions about the application of US GAAP while DCF resolves matters concerning the age, form, and content of financial statements required to be included in a filing. Even before a registrant requests reconsideration, DCF staff may have consulted internally about the issue with DCF-OCA and then with the OCA.
A registrant should initiate a reconsideration with OCA by informing the staff in DCF of its intention to request such reconsideration. In these circumstances, a registrant does not need to make a submission directly to OCA if all of the relevant information already is contained in comment letter responses from the registrant to DCF, although a separate submission to OCA may serve to expedite the process.

**Disclosure requirements**

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

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

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

**Requests for waivers, pre-clearance and interpretive guidance**

DCF staff has reminded registrants that it is better to “seek permission than forgiveness” as it relates to SEC reporting. To help reduce the risk of being questioned in the comment process on a complicated reporting matter, registrants may “pre-clear” their questions regarding financial reporting and disclosure information with DCF staff by submitting a formal pre-clearance request in writing on a named basis. DCF staff generally responds in writing to formal requests made in writing on a named basis within 10 business days.

Registrants also may request informal interpretive guidance from DCF staff on a named or no named basis in a telephone call to DCF staff or in a request form for interpretive guidance and other assistance on the SEC’s website. Requests made by telephone or an online request form\(^\text{11}\) are informal and may remain anonymous; however, responses to such requests cannot be relied upon as formal positions of DCF staff.

In addition, companies may pre-clear conclusions on the application of US GAAP (or IFRS) with the Commission’s Office of the Chief Accountant. OCA staff encourages companies to consult on a pre-filing basis when the company is uncertain about accounting issues. Further discussion of the procedures for consulting with OCA is on the SEC’s website at http://www.sec.gov/info/accountants/ocasubguidance.htm.

\(^{11}\) The online request form is available at: https://tts.sec.gov/cgi-bin/corp_fin_interpretive.
## Appendix D: Abbreviations

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